Intrafirm Monitoring of Executive Compensation

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This Article argues that employees should serve as intrafirm monitors of executive performance and pay. Employees and shareholders, labor and capital, can monitor executive performance and pay at different levels. Diffuse, diversified, and short durational shareholders currently monitor performance and pay through the market mechanism of public disclosures and share price. Employees can add an effective layer of monitoring by leveraging private information. Employees possess the corporation's entire information content; the assessment derived from this content would be relevant to the board's assessment of executive performance and pay. Corporate employees are also a major constituent of the corporate system and our political society. Given that excessive pay has been linked to economic inequity, employee monitoring can also validate executive pay in the current social, economic, and political environment in which executive compensation and income disparities have touched public consciousness. The basic structure of such monitoring already exists in law, as seen in shareholder say-on-pay mandated by the Dodd-Frank Act. Structured properly and achieved fairly as to senior executives, a non-binding employee vote would politically legitimize executive compensation and income disparity at both the firm and political levels.

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INTRODUCTION

Employees are not capital investors in the corporation, and they certainly do not have the level of standing that shareholders occupy in corporate law or governance.[1] Does this mean that they are irrelevant to the solution of one of the most important problems in modern corporate governance: systemic excessive executive compensation? To put it another way, do employees have relevant information on the performance of the chief executive officer (CEO), and if so, how can this information be elicited and used in an efficient manner within our system of corporate governance? This Article posits that employees can effectively assist the board of directors by serving as intrafirm monitors

1. Corporation statutes generally do not focus on the rights and powers of employees in corporate governance, at least not on the same level of shareholders. The most prominent provision dealing specifically with employees, and senior level employees in particular, is the provision dealing with indemnification and insurance. *See* DEL. CODE ANN. tit. 8, § 145 (2015) (providing right to "director, officer, employee or agent"); MODEL BUS. CORP. ACT § 8.56 (1969) (AM. BAR ASS'N, amended 2010) (indemnification of "officers"); *id.* at § 8.57 (insurance for "director or officer"); *see also* N. Am. Catholic Educ. Prog. Found., Inc. v. Gheewalla, 930 A.2d 92, 99 (Del. 2007) ("It is well established that the directors owe their fiduciary obligations to the corporation and its shareholders."); Malone v. Brincat, 722 A.2d 5, 9 (Del. 1998) ("This Court has held that a board of directors is under a fiduciary duty to disclose material information when seeking shareholder action."); Guth v. Loft, 5 A.2d 503, 510 (Del. 1939) ("Corporate officers and directors . . . stand in a fiduciary relation to the corporation and its stockholders.").

of executive pay while maintaining fidelity to the core principle that the board is the ultimate manager of the corporation's business and affairs.[2]

Executive pay is one of the most controversial topics in corporate governance.[3] Executive compensation started to rise significantly in the 1980s, experienced explosive growth in the 1990s, and rapidly outpaced the pay of the broader American workforce.[4] The systemic level of pay has created wide income disparity between top executives and the average worker.[5] The compensation problem has created a public perception of pay uncoupled from performance[6] and a broad sense of social inequity.[7] The legitimacy and efficacy of the corporate governance system are in question. Executive pay affects both firm efficiency and social equity in a market society; it influences incentives, which in turn affect production, wealth allocation, and risk selection.[8] A public sense that wages are not fairly allocated affects morale and social cohesion at

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2. *See* DEL. CODE ANN. tit. 8, § 141(a) (2015) ("The business and affairs of every corporation organized under this chapter shall be managed by or under the direction of a board of directors . . . "); MODEL BUS. CORP. ACT § 8.01(b) (1969) (AM. BAR ASS'N, amended 2010) ("All corporate powers shall be exercised by or under the authority of, and the business and affairs of the corporation managed by or under the direction of, its board of directors . . . .").

3. *See* Lisa M. Fairfax, *Sue on Pay: Say on Pay's Impact on Directors' Fiduciary Duties*, 55 ARIZ. L. REV. 1, 3 (2013) ("Undoubtedly, executive compensation is one of the most controversial corporate governance issues in recent years."); Troy A. Paredes, *Too Much Pay, Too Much Deference: Behavioral Corporate Finance, CEOs, and Corporate Governance*, 32 FLA. ST. U. L. REV. 673, 702 (2005) ("Executive compensation is one of the most controversial topics in corporate governance."). The scholarship on executive compensation, referencing the phenomenon of rapid growth and high level of compensation, is legion and too much to cite comprehensively. *See infra* Section I.A (describing the different camps of thought on whether there is a problem of executive compensation).

4. *See* Carola Frydman & Raven E. Saks, *Executive Compensation: A New View from a Long-Term Perspective, 1936-2005*, 23 REV. OF FIN. STUD. 2099, 2099 (2010) (showing that compensation was flat from 1940s to 1970s, but that pay became more correlated to shareholder wealth since the 1980s); Lawrence Mishel & Alyssa Davis, *Top CEOs Make 300 Times More Than Typical Workers* 3 tbl. 1, ECON. POL'Y INST. (June 21, 2015), http://www.epi.org/publication/ top-ceos-make-300-times-more-than-workers-pay-growth-surpasses-market-gains-and-the-rest-of-the-0-1-percent/ [https://perma.cc/4W5X-8QTQ] (showing historical growth of CEO pay as a multiple of average worker pay since 1965).

5. *See* Steven N. Kaplan & Joshua Rauh, *Wall Street and Main Street: What Contributes to the Rise in the Highest Incomes?*, 23 REV. OF FIN. STUD. 1004, 1004 (2010) (identifying executive compensation as one major source of the increasing income disparity seen in the last several decades).

6. *See generally* LUCIAN BEBCHUK & JESSE FRIED, PAY WITHOUT PERFORMANCE: THE UNFULFILLED PROMISE OF EXECUTIVE COMPENSATION (2004) (criticizing executive compensation practices).

7. *See* ROBERT W. KOLB, TOO MUCH IS NOT ENOUGH: INCENTIVES IN EXECUTIVE COMPENSATION 162 (2012) (arguing that "there is a growing awareness of the potential for rising inequity to seriously corrode social cohesion").

8. *See* Richard A. Posner, *Are American CEOs Overpaid, and, If So, What If Anything Should Be Done About It?*, 58 DUKE L.J. 1013, 1023–30 (2009) (discussing the relationship among incentives, risk selection, and firm production).

both firm and societal levels.[9] Prominent economists have identified executive compensation as a "powerful force"[10] for economic inequity and social "exploitation"[11] of wealth allocation through the abuse of corporate power.[12] Concentrated wealth affects both the working of the macro economy and social welfare.[13] Business scholars have called for a "new paradigm" on executive compensation.[14] Given this combined business, economic, and political reality, the current controversy over the compensation of CEOs will not ultimately recede into a private corner of corporate governance unless the problem is fixed.

Executive compensation has entered a new era. Until recently, compensation was not regulated in any meaningful way. It was a

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9. *See* William Lazonick, *Why Executive Pay Matters to Innovation and Inequity*, in THE EMBEDDED FIRM: CORPORATE GOVERNANCE, LABOR, AND FINANCE CAPITALISM 413, 415 (Cynthia Williams & Peer Zumbansen eds., 2011) (arguing that manipulation of executive pay has resulted in economic inequity, reduced innovation, and unstable economic performance).

10. THOMAS PIKETTY, CAPITAL IN THE TWENTY-FIRST CENTURY 334 (2014).

11. The economist and Nobel laureate Joseph Stiglitz provides this explanation:

> In a more careful, academic way of putting it I would say that one of the explanations of what is going on is increased exploitation. You see the ratio of wages to productivity going way down, and that certainly is consistent with increased exploitation. And you see that the ratio of CEO pay to worker pay has gone up. So what I would say is that some of the explanations have to do with weakened worker bargaining power, weaker unions, asymmetric state liberalization where capital moves but labor can't move, corporate governance laws that provide relatively little check on abuses of corporate power by CEOs, and an increase of monopoly power because of network externalities.

Lynn Parramore, *Joseph Stiglitz on Why the Rich Are Getting Richer—and Why It Could Get Much Worse*, HUFFINGTON POST (Dec. 19, 2014) (quoting Stiglitz), http://www.huffingtonpost.com/lynn-parramore/joseph-stiglitz-on-why-th_b_6354948.html [perma.cc/LC5T-TS5J].

12. *See* PIKETTY, *supra* note 10, at 334 ("[T]he extremely generous rewards meted out to top managers can be a powerful force for divergence of the wealth distribution: if the best paid individuals set their power salaries, (at least to some extent), the result may be greater and greater inequity."); JOSEPH E. STIGLITZ, THE PRICE OF INEQUALITY: HOW TODAY'S DIVIDED SOCIETY ENDANGERS OUR FUTURE 66–67 (2013) (providing an account of income inequity in the U.S. and asserting excessive executive pay as one of the causes); Lawrence Mishel & Natalie Sabadish, *CEO Pay and the Top 1%: How Executive Compensation and Financial-Sector Pay Have Fueled Income Inequality*, ECON. POL'Y INST. (May 2, 2012) (arguing that executive compensation and financial-sector pay have caused income inequity).

13. The credit rating agency, Standard & Poor's, has warned of the serious consequences of income inequity, which has been factored into bottom line projection of economic growth. *See* Joe Maguire, *How Increasing Inequity Is Dampening U.S. Economic Growth, and Possible Ways to Change the Tide*, GLOBAL CREDIT PORTAL (Aug. 5, 2014), https://www.globalcreditportal.com/ratingsdirect/renderArticle.do?articleId=1351366&SctArtId=255732&from=CM&nsl_code=LIME&sourceObjectId=8741033&sourceRevId=1&fee_ind=N&exp_date=20240804-19:41:13 [perma.cc/7AT2-FEC8]:

> At extreme levels, income inequality can harm sustained economic growth over long periods. The U.S. is approaching that threshold. Standard & Poor's sees extreme income inequality as a drag on long-run economic growth. We've reduced our 10-year U.S. growth forecast to a 2.5% rate. We expected 2.8% five years ago.

14. *See* Jay W. Lorsch & Rakesh Khurana, *The Pay Problem: Time for a New Paradigm for Executive Compensation*, in THE FUTURE OF BOARDS: MEETING THE GOVERNANCE CHALLENGES OF THE TWENTY-FIRST CENTURY 77 (2012).

matter of private contracting between the board and the executive. The Dodd-Frank Act now mandates voting on executive pay of public companies.[15] Since this reform measure is fairly new, its efficacy remains to be seen.[16] Irrespective of whether most voting outcomes approve proposed pay packages—the short but predictable experience thus far—say-on-pay is normatively desirable because shareholders now have a legal right to participate in the compensation decision. Their opinion is relevant to the board's deliberation, and relevant information facilitates informed decision-making.[17] Shareholder monitoring may prove to have long-term salutary effects.

Yet even as the ink is drying on the Dodd-Frank Act, the limits of shareholder monitoring are well known. Many shareholders in modern capital markets are rationally disengaged from corporate governance because they are diffuse and diversified and many have short-term investment horizons.[18] Furthermore, shareholders are only one of many contractual constituents of the firm.[19] One conception of a firm is a "nexus of contracts" among various factors of production.[20] This nexus includes not only top-level officers and the board, but also non-executive managers and rank and file employees who contribute to the production function of the firm.[21] Employees possess the firm's entire

15. Dodd-Frank Wall Street Reform and Consumer Protection Act, Pub. L. No. 111-203, § 951, 124 Stat. 1376 (2010).

16. *See generally* Randall S. Thomas et al., *Dodd-Frank's Say on Pay: Will It Lead to a Greater Role for Shareholders in Corporate Governance?*, 97 CORNELL L. REV. 1213 (2012) [hereinafter Thomas et al., *Dodd-Frank's Say on Pay*] (analyzing empirical data regarding voting trends); Randall S. Thomas et al., *The First Year of Say-on-Pay Under Dodd-Frank: An Empirical Analysis and Look Forward*, 81 GEO. WASH. L. REV. 967 (2013) [hereinafter Thomas et al., *First Year*] (providing preliminary empirical data on voting results).

17. *See* Lyman Johnson, *The Modest Business Judgment Rule*, 55 BUS. LAW. 625, 638–44, 642 n.78 (2000) (suggesting that the duty of care encompasses a "duty to be informed" and citing, among other cases, *Smith v. Van Gorkom*, 488 A.2d 858 (Del. 1985) and *Cinerama, Inc. v. Technicolor, Inc.*, 663 A.2d 1156 (Del. 1995)).

18. *See* ROBERT CHARLES CLARK, CORPORATE LAW 390–400 (1986) (discussing the problem of the rationally apathetic shareholder); Edward S. Adams, *Bridging the Gap Between Ownership and Control*, 34 J. CORP. L. 409, 422 (2009) (same); Michael S. Kang, *Shareholder Voting as Veto*, 88 IND. L.J. 1299, 1300 (2013) (same).

19. *See* R.H. Coase, *The Nature of the Firm*, 4 ECONOMICA 384, 390–91 (1937) (asserting that a firm is a set of contractual arrangements among various factors of production); *see also* STEPHEN M. BAINBRIDGE, THE NEW CORPORATE GOVERNANCE: IN THEORY AND PRACTICE 33–35 (2008) (explaining the nexus of contracts model of the corporation and identifying the various contractual constituents of the firm); Michael Jensen & William Meckling, *Theory of the Firm: Managerial Behavior*, 3 J. FIN. ECON. 305, 311 (1976) ("There is in a very real sense only a multitude of complex relationships (i.e., contracts) between the legal fiction (the firm) and the owners of labor, material and capital inputs and the consumers of output.").

20. Jensen & Meckling, *supra* note 19, at 310–11.

21. *See* Armen A. Alchian & Harold Demsetz, *Production, Information Costs, and Economic Organization*, 62 AM. ECON. REV. 777, 779 (1972) (discussing how organization of firms contributes

information.[22] Shareholders cannot claim the same; they depend on the capital market, which only incorporates publicly-disclosed information into the stock price.[23]

This Article advances the idea that a corporation and its board can use employees as intrafirm monitors of executive performance and pay. The advisory votes of shareholders and employees can provide an important and different source of information to the board. Two distinct benefits inure from granting employees the right to participate in pay decisions. First, from a microeconomic perspective of the firm, employees have a significant incentive to monitor the company and possess private information relevant to the performance of the company and its senior executives. Second, from a political economic perspective, employees can legitimize executive compensation in the public discourse; this aspect is important because executive compensation is no longer a purely private matter. One significant factor in growing economic inequity is high executive pay.[24] The political and economic advantages of permitting employee voice in executive compensation are significant.[25] With respect to implementation, the basic framework already exists in law today in the U.S. and globally, which is shareholder say-on-pay voting.[26]

The idea presented in this Article may be viewed as controversial since corporate governance as practiced today revolves around the triad of the board, management, and shareholder. The board ultimately manages the business and affairs of the corporation.[27] Corporate law grants shareholders the right to vote and a say on

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to the production function); Margaret M. Blair & Lynn A. Stout, *A Team Production Theory of Corporate Law*, 85 VA. L. REV. 247, 262 (1999) (diagramming the hierarchical structure of firms).

22. *See* PHILLIP PHAN, TAKING BACK THE BOARDROOM: THRIVING AS A 21ST-CENTURY DIRECTOR 3 (2007) ("There is increasing realization that a firm is a place where people meet to exchange specific information for the purpose of engaging in production.").

23. *See infra* Section III.A (discussing hypotheses of market efficiency).

24. *See* PIKETTY, *supra* note 10, at 334; STIGLITZ, *supra* note 12, at 66–67. *See generally* Daniel J. Morrissey, *Executive Compensation and Income Inequality*, 4 WM. & MARY BUS. L. REV. 1 (2013).

25. *See* RICHARD B. FREEMAN & JOEL ROGERS, WHAT WORKERS WANT 4 (1999) (noting that workers want more of a say and voice at the workplace); ALBERT O. HIRSCHMAN, EXIT, VOICE, AND LOYALTY: RESPONSES TO DECLINE IN FIRMS, ORGANIZATIONS, AND STATES 76–105 (1970) (analyzing the economic relationship between participatory voice and loyalty); Kenneth G. Dau-Schmidt, *Promoting Employee Voice in the American Economy: A Call for Comprehensive Reform*, 94 MARQ. L. REV. 765, 767 (2011) (suggesting that there is "under-representation of employee voice in the American economy").

26. *See* 15 U.S.C. § 78n–1(a)(1) (2012) (requiring shareholder approval of executive compensation no less frequently than once every three years); *see also infra* Section I.C (describing the international dimension of the say-on-pay laws).

27. DEL. CODE ANN. tit. 8, § 141(a) (2015); MODEL BUS. CORP. ACT § 8.01(b) (1969) (AM. BAR ASS'N, amended 2010).

compensation under the Dodd-Frank Act. Management has a close working relationship with the board that is generally, if not passively, supported by shareholders.[28] Employees have virtually no formal role in the internal affairs under U.S. corporate law.[29] The tension between our understanding of traditional corporate governance and the proposal advanced in this Article is more apparent than actual. The actual proposal, granting employees the right to have a say on pay, is consistent with one of the most fundamental tenets of corporate governance—informed decision-making by the board.[30]

To frame the analysis that follows, a few prefatory comments are warranted. This Article is about institutional design. It is not written to advance a broader agenda of expanding the employee's role in American corporate governance or comingling labor and corporate law, which are discrete fields.[31] The idea here is not based on a normative

28. *See infra* Section I.D (providing empirical data on say-on-pay voting); *see also* Aditi Bagchi, *Who Should Talk? What Counts as Employee Voice and Who Stands to Gain*, 94 MARQ. L. REV. 869, 875 (2011) (noting that shareholders can benefit if they "withdraw from their asymmetrical love affair with grossly overcompensated management").

29. *See* MARGARET M. BLAIR & MARK J. ROE, EMPLOYEES AND CORPORATE GOVERNANCE 2 (1999) ("Labor directly influences corporate governance structures in the United States less than it does . . . in some other countries."); Harry W. Arthurs & Claire Mummé, *From Governance to Political Economy: Insights from a Study of Relations Between Corporations and Workers*, *in* THE EMBEDDED FIRM: CORPORATE GOVERNANCE, LABOR, AND FINANCE CAPITALISM 350 (Cynthia Williams & Peer Zumbansen eds., 2011) ("The presumption is that workers will not participate in the making of important decisions, including many which directly and dramatically affect their interests."); Dau-Schmidt, *supra* note 25, at 767 ("In the American model of corporate governance, the shareholders and management are perpetually allied, leaving labor to fend for its interests largely through individual bargaining."); *see also* BLAIR & ROE, *supra*, at 163–313 (discussing the German and Japanese models); Dau-Schmidt, *supra* note 25, at 811–20 (same). *See generally* BLAIR & ROE, *supra* (analyzing employees' role in corporate governance); GREGORY K. DOW, GOVERNING THE FIRM: WORKERS' CONTROL IN THEORY AND PRACTICE (2003) (same); MICHAEL LOWER, EMPLOYEE PARTICIPATION IN GOVERNANCE: A LEGAL AND ETHICAL ANALYSIS (2010) (same). In Europe, employees have a greater role in corporate governance.

30. Informed decisionmaking is the core of a board's fiduciary duty of care. *See* Cede & Co. v. Technicolor, Inc., 634 A.2d 345, 367 (Del. 1993); *Smith v. Van Gorkom*, 488 A.2d 858, 872 (Del. 1985).

31. Corporation law and labor law are separate fields with traditionally recognized boundaries. *See* Bagchi, *supra* note 28, at 869 (noting the "barriers between labor law and corporate law"); Richard Mitchell et al., *Shareholder Value and Employee Interests: Intersections Between Corporate Governance, Corporate Law and Labor Law*, 23 WISC. INT'L L.J. 417, 417 (2005). However, scholars from both fields have sought to explore a greater role for employees in formal corporate governance. *See generally* Dau-Schmidt, *supra* note 25; Henry Hansmann, *Worker Participation and Corporate Governance*, 43 U. TORONTO L.J. 589 (1993); Sanford M. Jacoby, *Employee Representation and Corporate Governance: A Missing Link*, 3 U. PA. J. LAB. & EMP. L. 449 (2001); Brett H. McDonnell, *Strategies for an Employee Role in Corporate Governance*, 46 WAKE FOREST L. REV. 429 (2011); Brett H. McDonnell, *Employee Primacy, or Economics Meets Civic Republicanism at Work*, 13 STAN. J.L. BUS. & FIN. 334 (2008); Mitchell et al., *supra*. There are critics of such efforts; *see also generally* Bagchi, *supra* note 28; Aditi Bagchi, *Varieties of Employee Ownership: Some Unintended Consequences of Corporate Law and Labor Law*, 10 U. PA. J. LAB. & EMP. L. 305 (2008); Scott A. Moss, *Yes, Labor Markets Are Flawed—But So Is the*

judgment that broad employee participation in corporate governance should be an end. One should read this proposal from the perspective of corporate governance and law. The method is instrumental, advancing the use of an existing governance device to better monitor senior executives—a basic function of corporate governance. The starting premise of this Article is that there is a problem arising from failed arm's length bargaining between the board and the CEO, which is now the well-articulated Bebchuk-Fried thesis[32] and has been broadly accepted.[33] This Article does not rehash the debate on whether there is or is not a real problem with executive compensation.[34] There is a well-developed body of literature on the subject, and the literature on the problem of executive compensation is legion, which itself suggests that there are many commentators who believe there is a problem. From the orientation that there is in fact a problem of excessive pay, this Article explores the institutional design of intrafirm monitoring of executive pay and performance.

This Article proceeds in four sections. Section I provides brief background information on say-on-pay and identifies problems and limitations of shareholder voting. Section II proposes the concept of employee monitoring and describes the scheme's structure and implementation. Section III identifies the benefits of employee monitoring, and Section IV discusses potential objections.

I. SHAREHOLDER SAY

A. The Problem of Executive Pay

For much of the twentieth century, CEOs were paid well relative to other corporate workers, but, according to some prominent business scholars, they were paid on par with senior "bureaucrats."[35] Scholars

Economic Case for Mandating Employee Voice in Corporate Governance, 94 MARQ. L. REV. 959 (2011).

32. BEBCHUK & FRIED, *supra* note 6, at 23–44.

33. *See* Randall S. Thomas & Harwell Wells, *Executive Compensation in the Courts: Board Capture, Optimal Contracting, and Officers' Fiduciary Duties*, 95 MINN. L. REV. 846, 847–48 (2011) (noting that "the belief that the American executive compensation system works well is a distinctly minority position"); *see also* Posner, *supra* note 8, at 1014 ("The problem of executive compensation is not only real; it is more serious than I believed it to be . . . .").

34. *See infra* Section I.A and notes 49–55 and accompanying text.

35. Michael C. Jensen & Kevin J. Murphy, *CEO Incentives—It's Not How Much You Pay, But How*, HARV. BUS. REV. (May–June 1990), https://hbr.org/1990/05/ceo-incentives-its-not-how-much-you-pay-but-how [perma.cc/UKQ9-UWN3]; *see* Michael C. Jensen & Kevin J. Murphy, *Performance Pay and Top-Management Incentives*, 98 J. POL. ECON. 225, 262 (1990) (hypothesizing that market and political forces impose constraints that reduce performance incentives). However, even Jensen and Murphy have recently recognized that executive compensation schemes today are

suggested that contracts should be optimized to reduce agency cost, thereby justifying greater compensation as incentive for superior company performance.[36] In the 1990s, CEO pay experienced rapid growth and compensation levels have since remained at high levels relative to worker pay.[37] This growth has leveled off in the past several years, but what remains after the "big bang" in executive compensation is a new status quo in which top corporate executives are routinely paid wages that are several hundred times the pay of average workers.

Numerous studies have chronicled the rapid rise of executive compensation.[38] The following data on the level of executive pay and its relation to worker pay are from one such study (salary figures are adjusted to 2014 dollars).[39]

Year	CEO Compensation (incl. realized options)	Nonsupervisory Worker Compensation	Ratio of CEO-to-Nonsupervisory Worker Compensation	S&P 500 Index	Dow Jones Index
1965	832,000	40,200	20.7	579	5,986
1973	1,087,000	47,200	23.0	512	4,401
1978	1,487,000	48,000	31.0	320	2,735
1989	2,769,000	45,400	61.0	596	4,628
1995	5,862,000	46,000	127.4	836	6,941
2000	20,384,000	48,700	418.6	1,962	14,744
2007	18,786,000	51,100	367.6	1,687	15,048
2009	10,575,000	53,200	198.8	1,046	9,808
2010	12,662,000	53,700	235.8	1,238	11,585
2011	12,863,000	53,000	242.7	1,334	12,584
2012	14,998,000	52,600	285.1	1,422	13,371
2013	15,711,000	52,800	297.6	1,671	15,255
2014	16,316,000	53,200	306.7	1,931	16,778

seriously flawed. Kevin J. Murphy & Michael C. Jensen, *CEO Bonus Plans: And How to Fix Them*, (Harvard Business School NOM Unit Working Paper 12-022, 2011), http://ssrn.com/abstract=1935654 [perma.cc/J5WM-F5EZ].

36. *See* Murphy & Jensen, *supra* note 35, at 27–28 (discussing the use of "inappropriate performance measures" in setting executive compensation).

37. *See* STIGLITZ, *supra* note 12, at 66–67.

38. *Id.* at 296 n.12, 309 n.88 (providing citations to other sources and data).

39. Mishel & Davis, *supra* note 4, at 3 tbl. 1. Other studies and sources have shown slightly different numbers, but all show the same general trend and levels of high ratios of CEO pay. *See, e.g.*, Lorsch & Khurana, *supra* note 14, at 79 (showing ratio of average CEO pay to average worker pay growing from 44:1 in 1980 to 344:1 in 2007).

According to this study, the ratio of CEO to worker compensation accelerated from 1978 to 2014. In 1973, the ratio of CEO to worker pay was 23:1, but by 2014 it had ballooned to 306:1. Based on the above data, calculations of the annual growth rate from the period 1965 to 2014 are the following:[40]

▪ CEO pay	6.3%
▪ Worker pay	0.6%
▪ S&P 500	2.5%
▪ Dow Jones	2.1%.

CEO pay increased annually at a rate 11 times greater than worker pay. Furthermore, CEO pay outpaced the annual growth rate of the broader market indices by 2.5 to 3.0 times. This suggests that CEOs are paid at rate increases that are much greater than the increased value of the companies they are managing. We cannot explain executive pay by marginal productivity gains attributable to actions of senior executives.[41]

Executive pay packages were previously matters of internal corporate governance and private contracting—a closed world of boards, executives, and their advisers. As pay packages have rapidly increased in the past several decades and manipulations of compensation have been exposed, compensation has become a controversial public issue.

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40. This is simply internal rate of return calculations for the forty-nine years, from 1965 to 2014: future value (FV) = present value (PV) x $(1 + R)^T$ where R is the annual rate of return and T is time. Under this calculation, for example, a 6.3% return yields: \$832,000 x 1.063^{49} = \$16,316,000. Any slight differences in the calculations are due to rounding of the growth rate to the tenth of a percent.

41. *See* PIKETTY, *supra* note 10, at 334:

> The most convincing proof of the failure of corporate governance and of the absence of a rational productivity justification for extremely high executive pay is that when we collect data about individual firms (which we can do for publicly owned corporations in all the rich countries), it is very difficult to explain the observed variations in terms of firm performance.;

STIGLITZ, *supra* note 12, at 21:

> It strains credulity to think that over the intervening years CEOs as a group have increased their productivity so much, relative to the average worker, that a multiple of more than 200 could be justified. Indeed, the available data on the success of U.S. companies provide no support for such a view.;

Lucian A. Bebchuk & Yaniv Grinstein, *The Growth of Executive Pay*, 21 OXFORD REV. ECON. POL'Y 283 (2005) (concluding that the ratio of aggregate pay of the top five executives to the firm's earnings grew from 5% in 1993–1995 to about 10% in 2001–2003 and that this growth is beyond the increase that could be explained by firm size, industry classification, or company performance); Marianne Bertrand & Sendhil Mullainathan, *Are CEOs Rewarded for Luck? The Ones Without Principals Are*, 116 Q.J. ECON. 901, 901 (2001) (finding that CEO pay in fact responds as much to "a lucky dollar as to a general dollar" where luck is defined as factors of firm performance that are outside of the CEO's control).

Perhaps the most infamous episodes involved the outsized pay package of a former president of the Walt Disney Company for essentially several months of ineffective work,[42] and the "retention bonuses" for Wall Street investment bankers even as they were responsible for causing great economic damage to their firms and the global economy.[43] A recent study shows that many corporations pay their CEOs more than they pay in federal income taxes.[44] There is evidence that even payout policy on dividends and stock buybacks, a basic corporate financial decision, has been improperly affected by consideration of the CEO's wealth.[45]

Such episodes epitomize conspicuous compensation in an era of high economic inequity.[46] Although most issues of corporate governance

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42. *See In re* Walt Disney Derivative Litigation, 906 A.2d 27, 35 (Del. 2006) ("In December 1996, only fourteen months after he commenced employment, [Michael] Ovitz was terminated without cause, resulting in a severance payout to Ovitz valued at approximately $130 million."). This litigation was widely followed in the media. *See, e.g.*, Jonathan D. Glater, *Big Pay Packages May Fade After Ruling on Ex-President of Disney*, N.Y. TIMES (Aug. 10, 2005), http://www.nytimes.com/2005/08/10/business/media/big-pay-packages-may-fade-after-ruling-on-expresident-of-disney.html?_r=0 [perma.cc/6X6P-HJFP].

43. *See* Edmund L. Andrews & Peter Baker, *A.I.G. Planning Huge Bonuses After $170 Billion Bailout*, N.Y. TIMES, Mar. 14, 2009, at A1. The banks were so embarrassed to call the payouts "performance bonus" that they were instead called "retention bonus." STIGLITZ, *supra* note 12, at 79.

44. SCOTT KLINGER & SARAH ANDERSON, FLEECING UNCLE SAM: A GROWING NUMBER OF CORPORATIONS SPEND MORE ON EXECUTIVE COMPENSATION THAN FEDERAL INCOME TAXES, INSTITUTE FOR POLICY STUDIES AND CENTER FOR EFFECTIVE GOVERNMENT 1 (2014), http://www.ips-dc.org/wp-content/uploads/2014/11/IPS_Fleecing_Uncle_Sam_Report_Nov2014.pdf [perma.cc/DG8H-AR88]. The report finds that seven of the top thirty American corporations paid their CEOs more than they paid federal income taxes, and that twenty-nine of the hundred highest-paid CEOs received more in pay than their company paid in federal income taxes. *Id.* at 1.

45. *See* Philipp Geiler & Luc Renneboog, *Executive Remuneration and the Payout Decision* 23 (European Corp. Governance Inst. – Fin. Working Paper No. 420/2014, 2014), http://ssrn.com/abstract=2436343 [perma.cc/4MPE-K9J3] (discussing the effects of compensation manipulation on payout policy); Lazonick, *supra* note 9, at 424–37 (discussing the use of stock buybacks to manipulate compensation). Cash dividends reduce stock price. *See* RICHARD A. BREALEY ET AL., PRINCIPLES OF CORPORATE FINANCE 406–07 (11th ed. 2014) (showing how cash dividends reduce stock price). On the other hand, stock buybacks tend to increase share price. *See* ASWATH DAMODARAN, CORPORATE FINANCE: THEORY AND PRACTICE 687 (2d ed. 2001) ("A stock buyback reduces the number of shares outstanding and is often accompanied by a stock price increase."). If executive compensation were tied to stock price alone without a thoughtful contract or board analysis of performance, then executives would have incentive to manipulate stock price through payout policy.

46. *See* PIKETTY, *supra* note 10, at 334 (providing evidence of wealth inequity); *Forget the 1%: It Is the 0.01% Who Are Really Getting Ahead in America*, THE ECONOMIST (Nov. 8, 2014), http://www.economist.com/news/finance-and-economics/21631129-it-001-who-are-really-getting-ahead-america-forget-1 [perma.cc/7RNS-SV4Z] (same); Emmanuel Saez & Gabriel Zucman, *Wealth Inequity in the United States Since 1913: Evidence from Capitalized Income Tax Data* (Ctr. for Econ. Policy Research Discussion Paper No. DP10227, 2014), http://ssrn.com/abstract=2526356 [perma.cc/C9CY-C7R5] (same).

involve technical and arcane legal rules applied by an insular group of boards, the corporate bar, and mostly Delaware courts, the issue of executive compensation has become a public issue.[47] Corporate governance crises beget public awareness, as was the case in the 1990s and early 2000s resulting in the Sarbanes-Oxley Act and the financial crisis of 2008–2009 resulting in the Dodd-Frank Act.[48] Presently, executive compensation is squarely in the realm of public discourse.

There are two broad camps of thought on the current state of executive compensation. The first is the "optimal contracting" camp, which has argued that contracting for compensation works well and that the levels of compensation seen are the product of market pricing for executive talent.[49] The second is the "board capture" camp, which has argued that contracting has been undermined by failure of the board to monitor CEO performance and compensation. After a deluge of academic analyses, a general consensus has been reached that there is a problem with executive compensation.[50] The optimal contracting camp occupies a distinct minority position today.[51] This Article therefore accepts the premise of the prevailing view.

There is substantial evidence that the average board and CEO do not bargain at arm's length for compensation, and that CEOs have significant power and influence over the level of his or her own

47. *See, e.g.*, Robert Frank, *Another Widening Gap: The Haves vs. the Have-Mores*, N.Y. TIMES, Nov. 15, 2014, at BU4; Steven Rattner, Opinion, *Inequality, Unbelievably, Gets Worse*, N.Y. TIMES, Nov. 16, 2014, at A25.

48. *See* Hillary A. Sale, *Public Governance*, 81 GEO. WASH. L. REV. 1012, 1013 (2013) (arguing that public scrutiny of corporate governance arises when the ordinary private ordering of corporate governance fails and that "[d]ecisions about governance move from Wall Street to Main Street" as a result).

49. *See* JONATHAN R. MACEY, CORPORATE GOVERNANCE: PROMISES KEPT, PROMISES BROKEN 23 (2008) ("The specific executive compensation arrangements that we actually observe, however, simply reflect the result of a bargaining process between shareholders' elected representatives and managers."); John E. Core et al., *Is U.S. CEO Compensation Inefficient Pay Without Performance?*, 103 MICH. L. REV. 1142, 1159–60 (2005) (espousing "optimal contracting theory, which posits that contracts are designed to maximize shareholder value net of contracting costs and transactions costs"). Some commentators have even suggested that compensation levels in some cases may be too low. *See* Steven Kaplan, *Are U.S. CEOs Overpaid?*, 22 ACAD. MGMT. PERSP. 5, 6 (2008) ("It is possible that good CEOs are not overpaid, but underpaid.").

50. *See* Sorapop Kiatpongsan & Michael I. Norton, *How Much (More) Should CEOs Make? A Universal Desire for More Equal Pay*, 9 PERSPECTIVES IN PSYCHOLOGICAL SCIENCE 587, 588 (2014) (showing that most people, regardless of nationality, share similar beliefs on executive compensation and that their estimates are much lower than the actual amounts executives make); *see also* Gretchen Gavett, *CEOs Get Paid Too Much, According to Pretty Much Everyone*, HARV. BUS. REV. (Sept. 23, 2014), https://hbr.org/2014/09/ceos-get-paid-too-much-according-to-pretty-much-everyone-in-the-world/ [perma.cc/3U3X-WXRU] (providing a summary of Kiatpongsan and Norton's paper).

51. Thomas & Wells, *supra* note 33, at 847–48.

compensation.[52] The most powerful advocates of this critique have been Lucian Bebchuk and Jesse Fried.[53] Due to managerial power and position, CEOs collect large economic rents.[54] In a pre-Dodd-Frank era, Bebchuk and Fried argued that both shareholders and the market have limited influence to curb excessive pay.[55] Their criticism has proved durable even in a post-Dodd-Frank era of shareholder say-on-pay.

However, the premise of this Article goes beyond shareholder-centrism.[56] Advocates of shareholder primacy do not connect the role of executive compensation to the broader problem of economic inequity. Their concern is the maximization of shareholder wealth.[57] Presumably much of the criticism of the "board capture" camp would go silent if the current compensation levels were strongly connected to shareholder wealth. For example, one can argue that executives can be paid up to the point at which marginal corporate wealth gain equals marginal salary increase. But such an analysis may prove to be too simplistic because it does not answer the question of distribution of corporate wealth as among shareholders, executives, and employees. The connection between executive pay and income inequity should be recognized because this aspect of corporate governance imposes broad externalities beyond senior executives and shareholders.[58] There is also

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52. *See* BEBCHUK & FRIED, *supra* note 6, at 23–44, 61–86.

53. *Id.*

54. *See* STIGLITZ, *supra* note 12, at 65 ("One of the interpretations . . . is that . . . corporate managers seized a larger share of the 'rents' associated with corporations."); Lucian Arye Bebchuk, Jesse M. Fried & David I. Walker, *Managerial Power and Rent Extraction in the Design of Executive Compensation*, 69 U. CHI. L. REV. 751, 783 (2002) ("Managers with power are able to extract "rents"—value in excess of that which they would receive under optimal contracting—and managers with more power can extract more rents."). Economic rent is derived "from the strategic advantage that . . . management possesses in the distribution of the returns to monopoly power." Oliver E. Williamson, *Managerial Discretion and Business Behavior*, 53 AM. ECON. REV. 1032, 1035 (1963).

55. BEBCHUK & FRIED, *supra* note 6, at 45–58.

56. *See generally* Lucian A. Bebchuk, *The Myth of Shareholder Franchise*, 93 VA. L. REV. 675 (2007) [hereinafter Bebchuk, *Shareholder Franchise*] (arguing that shareholder power to control corporate democracy is exaggerated, and may in fact not even exist); Lucian Arye Bebchuk, *The Case for Increasing Shareholder Power*, 118 HARV. L. REV. 833 (2005) [hereinafter Bebchuk, *Shareholder Power*] (advocating for an increase in shareholders' abilities to intervene and affect corporate governance arrangements).

57. *See* Henry Hansmann & Reinier Kraakman, *The End of History for Corporate Law*, 89 GEO. L.J. 439, 439 (2001) (noting that "shareholder-centered ideology of corporate law" has become a dominant orthodox value).

58. *See* PIKETTY, *supra* note 10, at 334 ("[T]he extremely generous rewards meted out to top managers can be a powerful force for divergence of the wealth distribution" with the likely results being "greater and greater inequality."); STIGLITZ, *supra* note 12, at 66–67 (describing how the shift in U.S. corporate governance laws since the mid-1970s has allowed managers to "entrench and protect their interests . . . to take a larger share of the corporate rents for themselves with impunity.").

a larger question of social equity. The distribution of the gains currently results in excessively large allocations to a small handful of senior executives even though production in a corporation is always a collective endeavor utilizing many factors of production, including employees.[59]

With that said, shareholder primacy and social equity may not be binary choices. The most efficient outcome for shareholders may be lower compensation levels for senior executives on the whole.[60] Shareholders may get the same performance for less pay, in which case shareholders would gain. Less systemic rent extraction would result in lower aggregate pay levels. Shareholders and employees may agree upon this outcome. Since shareholders comprise a much broader spectrum of society than the class of senior executives, this outcome would tend to make income and wealth distributions more equitable across the corporation and society.

B. Limits of Delaware Corporation Law

When discussing a failure of an aspect of corporate governance, some may consider the font of reform to lie in state corporate law.[61] This thought is more hopeful than real.[62] There are impediments to any serious reform through state corporate law.

First is the problem of politics and money. Delaware reigns supreme in corporate law, particularly for public corporations—where the problem of compensation is most acute.[63] Delaware law is regarded

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59. *See* Alchian & Demsetz, *supra* note 21, at 779–81 ("With team production it is difficult, solely by observing total output, to either define or determine *each* individual's contribution to this output of the cooperating inputs."); Blair & Stout, *supra* note 21, at 287–319 (providing an analysis of the team production model as a better "basis for understanding the unique economic and legal functions served by the public corporation" than alternative theories).

60. *See* BEBCHUK & FRIED, *supra* note 6, at 1–7, 9–10 (criticizing the aggregate dollar values of compensation).

61. *See, e.g.*, Lisa M. Fairfax, *Sue on Pay: Say on Pay's Impact on Directors' Fiduciary Duties*, 55 ARIZ. L. REV. 1, 44–46 (2013) (focusing on negative say-on-pay votes as a basis for fiduciary obligations of boards and the importance of state-based enforcement mechanisms); Thomas & Wells, *supra* note 33, at 847–48 (focusing on Delaware courts' recent increased scrutiny of the fiduciary duty of officers in the contracting process); Steven C. Caywood, Note, *Wasting the Corporate Waste Doctrine: How the Doctrine Can Provide a Viable Solution in Controlling Excessive Executive Compensation*, 109 MICH. L. REV. 111, 117–19 (2010) (contrasting the historical reluctance of Delaware courts in applying the corporate waste doctrine, with the doctrine's recent perceived resurgence).

62. *See* BEBCHUK & FRIED, *supra* note 6, at 45–46 ("[J]udicial review has failed to impose any meaningful constraint[s] on executive pay.").

63. *See* Lucian A. Bebchuk et al., *Does the Evidence Favor State Competition in Corporate Law?*, 90 CALIF. L. REV. 1775, 1810 (2002) (providing statistical evidence that over half of all public companies that incorporate in the United States incorporate in Delaware).

as a kind of a quasi-national corporate law, and its judiciary enjoys the well-earned reputation as preeminent corporate jurists.[64] This expertise is a competitive advantage for the state and generates significant revenue.[65] Since meaningful reform of excessive compensation would most likely result in a systemic decrease in compensation, any semblance of real reform in Delaware would be exposed to the real risk of a "compensation run" to other jurisdictions by those holding the decision-making power. Management will want to avoid jurisdictions that actively scrutinize the grant of compensation. There would be literally millions of reasons to forsake Delaware. Knowing this, both the Delaware legislature and courts will not take action that would seriously compromise the state's franchise.[66]

With this perspective in mind, Delaware courts have applied the traditional doctrines of fiduciary duty, the business judgment rule, and corporate waste to review compensation in disputed cases.[67] This framework gives a board virtually unfettered discretion to award whatever compensation it decides,[68] absent culpable conduct arising from disloyalty, bad faith, bad process, faulty disclosure, waste, or

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64. *See generally* Randy J. Holland, *Delaware's Business Courts: Litigation Leadership*, 34 J. CORP. L. 771 (2009) (detailing the deference and authority afforded to the Delaware courts in modern business law).

65. *See* Mark J. Roe, *Delaware's Shrinking Half-Life*, 62 STAN. L. REV. 125, 130–37 (2009) [hereinafter Roe, *Shrinking Half-Life*] (discussing revenue generated for Delaware through incorporation in the state); Mark J. Roe, *Delaware's Politics*, 118 HARV. L. REV. 2491, 2497–99 (2005) [hereinafter Roe, *Politics*] ("Delaware's freedom to act and its limits are not determined solely . . . by its strength vis-à-vis other states, but by the line demarcating where the federal authorities leave it alone and where they do not.").

66. On the occasion when the Delaware courts took action that was deemed significantly against the interests of corporate management, the legislature took immediate action to legislatively overrule the court. Of course, this is exemplified by the famous episode of *Smith v. Van Gorkom*, 488 A.2d 858 (Del. 1985), and the subsequent enactment of the exculpation provision in DEL. CODE ANN. tit. 8, § 102(b)(7) (2015). *See* Robert J. Rhee, *Fiduciary Exemption for Public Necessity: Shareholder Profit, Public Good, and the Hobson's Choice During a National Crisis,* 17 GEO. MASON L. REV. 661, 682–83 (2010) ("The decision in *Smith v. Van Gorkom* resulted in the enactment of DGCL section 102(b)(7).").

67. *See* Thomas & Wells, *supra* note 33, at 865–80 (describing the history and methods of Delaware courts evaluating excessive compensation claims).

68. *See, e.g.*, *In re* Walt Disney Co. Derivative Litig., 906 A.2d 27, 70–75 (Del. 2006) (upholding severance payout of $130 million to a fired executive because it did not constitute waste); Zucker v. Andreessen, C.A. No. 6014-VCP, 2012 WL 2366448, at *3–4, *7–10 (Del. Ch. June 21, 2012) (ruling a severance package worth $40 million given to a fired executive did not meet the waste standard, even though defendant was under no contractual obligation to pay the executive any severance); In re Goldman Sachs Group, Inc. S'holder Litig., C.A. No. 5215-VCG, 2011 WL 4826104, at *23 (Del. Ch. Oct. 12, 2011) (holding that compensation levels at Goldman Sachs and the potential risks they posed could only support a conclusion that the directors made "poor business decisions" and thus were within the scope of the business judgment rule).

outright fraud.[69] As long as the board makes an informed, good faith decision and does not mislead shareholders in doing so, its decision is effectively bulletproof. Any amount, no matter how gross or excessive, would be proper under corporate law,[70] subject only to the theoretical limit of the corporate waste doctrine.[71] Based on this legal framework, courts have predictably dismissed derivative suits based on negative shareholder say-on-pay votes in the vast majority of cases.[72]

In the past three decades, as executive compensation has increased conspicuously and as courts have been forced to decide highly controversial cases like the *Disney* litigation,[73] what have judges done about the problem? No new doctrines have been developed to address the issue.[74] Although there were some instances in which courts threatened higher scrutiny, they have since returned to managerial deference as public dissatisfaction has subsided.[75] As commentators noted, shareholders occasionally succeeded in cases "at some stage of the litigation process."[76] This qualifier is important because what really matters for changing behavior and, more importantly, outcomes is a finding of liability or the imposition of a cost. The mere threat of liability is not credible enough unless there is also a real possibility of liability under the theory of excessive compensation.[77] There has been no case

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69. State corporation law is most effective as a check on executive compensation when there has been fraud or major defects in disclosure. *See, e.g.*, Weiss v. Swanson, 948 A.2d 433 (Del. Ch. 2008) (denying corporate defendant's motion to dismiss because shareholder plaintiff sufficiently pled claims of improper disclosure and corporate waste in relation to stock option manipulation); Ryan v. Gifford, 918 A.2d 341 (Del. Ch. 2007) (denying corporate defendant's motion to dismiss because shareholder plaintiff rebutted business judgment rule deference through claims of defendant's fraudulent concealment of wrongdoing).

70. *See, e.g.*, *In re Walt Disney Co. Derivative Litig.*, 906 A.2d at 35 (upholding severance compensation worth $130 million paid to fired executive for fourteen months of ineffective work).

71. *See* Brehm v. Eisner, 746 A.2d 244, 264 (Del. 2000) ("Irrationality is the outer limit of the business judgment rule" and "the functional equivalent of the waste test."). Waste occurs "only in the rare, 'unconscionable case where [a board] irrationally squander[s] . . . corporate assets.' " *In re Walt Disney Co. Derivative Litig.*, 906 A.2d at 74 (quoting *Brehm*, 746 A.2d at 263). As such, the exception for finding executorial liability absent evidence of "conflict of interest or improper motivation" has been described as "theoretical." Gagliardi v. TriFoods Int'l, Inc., 683 A.2d 1049, 1051–52 (Del. Ch. 1996).

72. *See* Fairfax, *supra* note 61, at 23–25 (describing the role of say on pay suits in current derivative litigation, and noting that such suits are "dismissed at the pleading stage with overwhelming frequency").

73. *In re Walt Disney Co. Derivative Litig.*, 906 A.2d 27.

74. *See* Thomas & Wells, *supra* note 33, at 880 (noting that the weakness of the waste doctrine and the "lack of any alternative, practicable approach" to scrutinizing executive compensation has hampered courts).

75. *See id.* at 879–80.

76. *Id.*

77. *See* Robert J. Rhee, *The Tort Foundation of Duty of Care and Business Judgment*, 88 NOTRE DAME L. REV. 1139, 1154 (2013) ("The ultimate source of the expressive value of judicial

where a court struck down a compensation decision solely based on the excessiveness of the pay.[78]

Courts justify shying away from interfering with the substantive terms of the employment contract between the corporation and the CEO, if the contract is the product of actual arms-length bargaining, by using longstanding doctrine. Judicial meddling in specific contract terms—such as the amount of compensation—would be frowned upon. Courts can certainly apply their own judgment on the matter,[79] but this contravenes long-existing pillars of corporation law of giving boards deference when they act in an informed manner and on a good faith basis.[80] The board has the authority to decide the business and affairs of the corporation.[81] This authority necessitates the business judgment rule, which is a socially useful rule limiting the liability for officers and directors.[82] Good, bad, or ugly, corporate governance under current standards is stuck with the decisions of boards.[83]

Thinking within the framework of existing corporate law, commentators have suggested a potential check on self-interested negotiation for compensation could be the fiduciary duty of corporate officers.[84] However, there are reasons to be less sanguine about the efficacy of this route to reform. As a contracting counterparty to the corporation, executives are entitled to pursue their self-interested economic goals. One cannot realistically expect an executive to bargain with herself to the detriment of her own self-interest. Fiduciary duty

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opinions is derived solely from the power to assess liability (*i.e.*, a consultant in a black robe is still just a consultant).").

78. *See* Thomas & Wells, *supra* note 33, at 880 ("[Courts] have been hampered, at least in part, by the waste doctrine and its inherent weaknesses, and by lack of any alternative, practicable approach to scrutinizing compensation."). However, when board action fits within traditional theories of misconduct, such as faulty disclosure or waste, courts have acted in the compensation arena. *See supra* note 69; *infra* note 102.

79. *See* Rhee, *supra* note 77, at 1152 ("Despite frequent assertions, scholars have been rightfully skeptical of the argument that courts lack the technical competence to review business decisions.").

80. Aronson v. Lewis, 473 A.2d 805, 812 (Del. 1984) (the business judgment rule "is a presumption that in making a business decision the directors . . . acted on an informed basis, in good faith and in the honest belief that the action taken was in the best interests of the company").

81. DEL. CODE ANN. tit. 8, § 141(a) (2015); MODEL BUS. CORP. ACT § 8.01(b) (1969) (AM. BAR ASS'N, amended 2010).

82. *See* Rhee, *supra* note 77, at 1140 (noting that rules limiting the liability of shareholders and directors are two pillars of corporation law).

83. *See In re* Caremark Int'l Inc. Derivative Litig., 698 A.2d 959, 967 (Del. Ch. 1996) ("[W]hether a judge or jury considering the matter after the fact, believes a decision substantively wrong, or degrees of wrong extending through 'stupid' to 'egregious' or 'irrational,' provides no ground for director liability . . . .").

84. *See* Thomas & Wells, *supra* note 33, 848–49 (citing Gantler v. Stephens, 965 A.2d 695, 708–09 (Del. 2009) ("[C]ourts have a stronger doctrine they can employ . . . to monitor abuses in executive compensation: the fiduciary duties of officers.").

cannot go so far as to suggest that employees and agents should be charities to the firm or that they have a duty to ignore their primary economic interest of vigorously bargaining their wage or stake.[85] Even before the explicit recognition of an officer's fiduciary duty in Delaware, the common assumption was that officers were fiduciaries, and so the rise in executive compensation proceeded with this understanding.[86] Furthermore, public companies are required to have independent board members on their compensation committees.[87] In theory, at least, board independence should achieve an outcome largely similar to officers contracting under the halo of fiduciary duty.

Courts are also not incapable of developing new doctrines to address new business climates on fairly short notice. Delaware courts rapidly developed new doctrines to confront the realities of the takeover and leveraged buyout eras of the 1980s and 1990s.[88] In executive compensation, however, there have been no similar judicial innovations to design a review system tailored to the specific problem at hand.[89] This has not been for lack of good test cases able to serve as vehicles for judicial action. For example, the Delaware court openly acknowledged that the circumstances in *Disney* did not display the model corporate

85. Analogously, courts have stated that partners owe a fiduciary duty that is "[n]ot honesty alone, but the punctilio of an honor the most sensitive." Meinhard v. Salmon, 164 N.E. 545, 546 (N.Y. 1928). But partnership law also makes clear that a partner's conduct does not violate fiduciary duty "merely because the partner's conduct furthers the partner's own interest." REVISED UNIF. P'SHIP ACT § 404(e) (AM. BAR ASS'N & UNIF. LAW COMM'N 1997).

86. *See* Gantler v. Stephens, 965 A.2d 708–09 (citing Guth v. Loft, Inc., 5 A.2d 503, 510 (Del. 1939); Cede & Co. v. Technicolor, Inc., 634 A.2d 345, 361 (Del. 1993)) ("In the past, we have implied that officers of Delaware corporations, like directors, owe fiduciary duties of care and loyalty, and that the fiduciary duties of officers are the same as those of directors.").

87. Dodd-Frank Wall Street Reform and Consumer Protection Act, Pub. L. No. 111-203, § 952(a), 124 Stat. 1376, 1900–01 (2010) (amending the Securities Exchange Act of 1934, § 10, 15 U.S.C. §78); *see* NEW YORK STOCK EXCHANGE, LISTED COMPANY MANUAL § 303A.05(a), http://nysemanual.nyse.com/LCMTools/bookmark.asp?id=sx-ruling-nyse-policymanual_3&manual=/lcm/sections/lcm-sections/ [perma.cc/PS6Z-L8DS] (last visited Jan. 10, 2016) (*amended by* NYSE-2012-49 (Jan. 11, 2013)) ("Listed companies must have a compensation committee composed entirely of independent directors.").

88. *See, e.g.*, Paramount Commc'ns, Inc. v. QVC Network Inc., 637 A.2d 34, 43–48 (Del. 1993) (applying an enhanced level of judicial scrutiny to board decisions when sale of control was implicated); Revlon, Inc. v. MacAndrews & Forbes Holdings, Inc., 506 A.2d 173, 179–82 (Del. 1986) (determining directorial fiduciary duties in the context of a cash buyout); Unocal Corp. v. Mesa Petroleum Co., 493 A.2d 946, 957–59 (Del. 1985) (determining the applicable scrutiny for reviewing management's defensive measures in the context of a takeover situation).

89. Some commentators have proposed modifications to Delaware's laws of fiduciary duty and judicial review. *See* Fairfax, *supra* note 61, at 48–50 (arguing for Delaware courts to utilize say on pay votes to alter the standard used when examining questions of executive compensation); Thomas & Wells, *supra* note 33, at 880–97 (advocating for judicial recognition of officers' fiduciary duties and increased scrutiny of actions implicating those duties to allow courts to discipline excessive compensation).

governance structure;[90] yet bad facts such as those in *Disney*[91] were insufficient to construct a new doctrine specific to governance failure in compensation.

Doctrinal innovations are possible, but their lack of existence is a juridical choice. As a state supreme court, the Delaware Supreme Court could set forth a bright-line rule on a presumption of validity. For illustrative purposes, consider a rule where a ratio of more than 100:1 between the CEO's compensation and the lowest paid employee's compensation would be scrutinized under a higher standard such as the entire fairness standard.[92] Such bright-line standards are more common in the legislative process, but there are prominent examples from U.S. Supreme Court jurisprudence of judicially-set quantitative limits.[93] Or consider the possibility of announcing an intermediate scrutiny for severance pay or golden parachutes based on a multifactor reasonableness standard, such as the benefit to the corporation, the corporation's ability to attract executive talent, the length of tenure, the quality of past service, and other relevant facts.[94] These cursory examples are suggested to show merely that there may be not-absurd

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90. *See In re* Walt Disney Co. Derivative Litig. 906 A.2d 27, 56–57 (Del. 2006) (observing that the compensation committee's decision-making process fell short of best practices).

91. *See id.* at 35–36 (upholding severance compensation of $130 million for fourteen months of work by a former company president, despite trial evidence showing he was ineffective and that the decision to hire him was flawed).

92. *See* Cede & Co. v. Technicolor, Inc., 634 A.2d 345, 361 (Del. 1993) ("Under the entire fairness standard of judicial review, the defendant directors must establish to the court's satisfaction that the transaction was the product of both fair dealing and fair price." (citing Nixon v. Blackwell, 626 A.2d 1366, 1376 (Del. 1993) ("The entire fairness analysis essentially requires 'judicial scrutiny.' "); Weinberger v. UOP, Inc., 457 A.2d 701, 710 (Del. 1983) ("The concept of fairness has two basic aspects: fair dealing and fair price."))).

93. *See, e.g.*, Grutter v. Bollinger, 539 U.S. 306, 343 (2003) (upholding the constitutionality of Michigan Law School's "narrowly tailored use of race in admissions decisions" and stating that "[w]e expect that 25 years from now, the use of racial preferences will no longer be necessary to further the interest approved today"); State Farm Mut. Auto. Ins. Co. v. Campbell, 538 U.S. 408, 425 (2003) ("Our jurisprudence and the principles it has now established demonstrate . . . few awards exceeding a single-digit ratio between punitive and compensatory damages . . . will satisfy due process.").

94. Under the common law process of corporation law, a court could condition the application of the business judgment rule on meeting strict judicial conditions. *See, e.g.*, *In re* MFW S'holder Litig., 67 A.3d 496 (Del. Ch. 2013). This case involved a controlling shareholder who initiated a going private transaction, and conditioned the deal upon approval by an independent committee and a majority-of-the-minority shareholder vote. The court provided the standard of review and the necessary conditions:

> The business judgment rule is only invoked if: (i) the controller conditions the procession of the transaction on the approval of both a special committee and a majority of the minority stockholders; (ii) the special committee is independent; (iii) the special committee is empowered to freely select its own advisors and to say no definitively; (iv) the special committee meets its duty of care; (v) the vote of the minority is informed; and (vi) there is no coercion of the minority.

Id. at 535.

possibilities in which a thoughtful common law process could experiment and fashion rules of law sufficiently malleable to the particular social problem at hand if a court had the desire to go down this road.[95]

If Delaware wanted to do something about the problem, it could have done so and it has had recurring opportunities to restructure the framework of fiduciary duty, business judgment rule, and corporate waste.[96] But it is unlikely that Delaware will ever take leadership of the issue. One need not be a Delaware naysayer[97] to believe that Delaware courts are not inclined to exercise judicial power to reform executive compensation on a national level in a way that could potentially risk the prestige and economics of the state's corporation law franchise.

Without state legislative mandate, the erection of new doctrinal frameworks to address executive compensation is a step too far for the Delaware corporate bench.[98] Courts would have to go outside their

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95. Much of Delaware corporate law, though statute originated, is developed through the common law process. *See id.* at 528 (recognizing the common law approach of Delaware corporation law); Marcel Kahan & Edward Rock, *Symbiotic Federalism and the Structure of Corporate Law*, 58 VAND. L. REV. 1573, 1610 (2005) ("Delaware corporate law may be the last vestige of the 19th century common law style in America."); E. Norman Veasey with Christine T. Di Guglielmo, *What Happened in Delaware Corporate Law and Governance from 1992-2004? A Retrospective on Some Key Developments*, 153 U. PA. L. REV. 1399, 1411 (2005) ("Delaware's common law process, which places case law at the forefront of corporate law, is the functional equivalent of judicial legislation.").

96. *See supra* note 68.

97. *See* William L. Cary, *Federalism and Corporate Law: Reflections Upon Delaware*, 83 YALE L.J. 663, 696–705 (1974) (arguing that federal standards of responsibility be enacted in corporation law to offset the Delaware-led "race to the bottom" by the states). The question of whether corporation law is engaged in a "race to the bottom" or a "race to the top" has spawned a vigorous debate. *Compare id.* at 665–66 (explaining the "race to the bottom" argument in the context of states' loosening of corporation law to attract and retain businesses away from other states), *with* Ralph K. Winter, Jr., *State Law, Shareholder Protection, and the Theory of the Corporation*, 6 J. LEGAL STUD. 251, 256–58 (1977) [hereinafter Winter, Jr., *Theory of the Corporation*] (arguing that other states changing their corporation laws to compete with Delaware for tax revenue indicates a "race to the top" designed for companies to maximize capital), *and* Ralph Winter, *Private Goals and Competition Among State Legal Systems*, 6 HARV. J.L. & PUB. POL'Y 127, 128–30 (1982) [hereinafter Winter, *Private Goals*] (explaining that, "[a]s long as . . . there is real competition to make money through attracting corporate charters, Delaware will not tilt toward management" and is thus engaged in a "race to the top").

98. In contrast, Delaware courts have created new doctrines, including different standards of review, to address other kinds of problems in corporation law—including in the takeover arena. *See, e.g.*, Unocal Corp. v. Mesa Petroleum Co., 493 A.2d 946, 954–59 (Del. 1985) (creating and applying an intermediate, two-part standard to review a board's defensive action against a hostile acquirer); *see also* William T. Allen, Jack B. Jacobs & Leo E. Strine, Jr., *Function Over Form: A Reassessment of Standards of Review in Delaware Corporation Law*, 56 BUS. LAW. 1287, 1291–94 (2001) (explaining how the Delaware courts developed new doctrines "because the new forms of merger transactions and board responses to unsolicited takeover bids . . . demand[ed] more flexible judicial tools specifically adapted" to address the "dynamic revolution in corporate merger activity" facing the courts).

comfort zone and familiar doctrinal habits; they would also have to envision, or to acknowledge openly, a regulatory function of corporate law, which would run counter to the conventional refrain that corporate law is enabling.[99] As the Delaware chancery court stated, "[t]he decision as to how much compensation is appropriate to retain and incentivize employees, both individually and in the aggregate, is a core function of a board of directors exercising its business judgment."[100] State corporate law is designed to give maximum authority and discretion to informed, non–bad faith decisions on the amount of the pay.[101] Delaware courts are not a serious solution to the problem of excessive pay.[102] This conclusion is an unremarkable observation of the current limits of state corporate law. The politics of revenue-generative lawmaking business, the legitimacy of longstanding foundational doctrines, and the tension between judicial inertia and activism when *stare decisis* confronts new social problems limit corporate common law's effectiveness in this area.

C. Shareholder Say-on-Pay

Compensation regulation must be prescribed by legislation. This understanding gave rise to the say-on-pay phenomenon, which is a fairly new concept.[103] The idea originated in the U.K., where say-on-pay was enacted in 2002.[104] Other countries with advanced economies soon followed. Australia and the Netherlands enacted laws in 2004, Sweden

99. *See* Shintom Co., Ltd. v. Audiovox Corp., 888 A.2d 225, 227 (Del. 2005) ("The Delaware General Corporation Law is an enabling statute . . . ."); William T. Allen, *Contracts and Communities in Corporation Law*, 50 WASH. & LEE L. REV. 1395, 1400 (1993) ("United States corporate law is thus chiefly enabling in character, not regulatory.").

100. *In re* Goldman Sachs Grp., Inc. S'holder Litig., No. 5215-VCG, 2011 WL 4826104, at *14 (Del. Ch. Oct. 12, 2011).

101. *See* Lisa R. Stark, *Delaware Insider: Do Stockholders Have a "Say on Pay" in Delaware? Lessons from Recent Executive Compensation Decisions*, BUS. L. TODAY, Sept. 2012, at 1, 3 ("Stockholders seeking to challenge compensation decisions made by disinterested and informed directors have an uphill battle in Delaware.").

102. There are the occasional rulings that seem to acknowledge the problem of executive compensation. *See* Thomas & Wells, *supra* note 33, at 879–80 ("[C]ourts, even Delaware's allegedly promanagement courts, have at times been willing to impose . . . higher scrutiny for executive compensation."); *see, e.g.*, *In re* Citigroup Inc. S'holder Derivative Litig., 964 A.2d 106, 139 (Del. Ch. 2009) (denying defendant corporation's motion to dismiss a claim of waste relating to the compensation package granted to retiring CEO during the subprime lending market depression at the pleading stage). However, these cases work within the traditional framework of the corporate waste doctrine, which is an exceedingly difficult standard to meet. *See supra* note 71.

103. For a history, see Thomas et al., *Dodd-Frank's Say on Pay*, *supra* note 16, at 1217–36.

104. *Id.* at 1226.

in 2006, and Norway in 2007.[105] The rapid adoption of say-on-pay in other advanced economies indicates a global perception of a problem in executive compensation.

In the U.S., nascent efforts to influence the board's discretion in compensation came in the form of shareholder proxy proposals.[106] But these efforts were sporadic and depended on shareholder initiative. Say-on-pay first became a federal regulatory requirement in 2008 and 2009, when financial firms receiving TARP funds were required to institute shareholder say-on-pay.[107] During this time, another high profile executive compensation episode captured the public's attention. While the financial markets were collapsing and the American public was suffering through the worst economic downturn since the Great Depression,[108] Wall Street investment bankers and executives received enormous "retention" bonuses.[109] The decoupling of pay and performance on Wall Street was complete in this case. Since state laws were insufficient to address these problems, the federal government intervened.[110]

With the enactment of the Dodd-Frank Act, the mandate of say-on-pay was extended broadly to all U.S. public companies.[111] The statute requires that companies allow a shareholder vote to approve executive compensation packages at least every 3 years.[112] It also mandates votes on both the frequency of the vote and golden parachute

105. *Id.* at 1227. *See* Jan Lieder & Philipp Fischer, *The Say-on-Pay Movement—Evidence from a Comparative Perspective*, 8 EUR. COMPANY & FIN. L. REV. 376, 381–87, 392–98 (2011) (discussing say-on-pay in Europe).

106. The first shareholder say-on-pay proxy proposals were submitted under Rule 14a-8 in 2006. Thomas et al., *Dodd Frank's Say on Pay*, *supra* note 16, at 1217. By 2009, say-on-pay proposals were the largest category of shareholder proxy proposals and regularly achieved majority shareholder support. *Id.* at 1217–18.

107. Emergency Economic Stabilization Act of 2008, 12 U.S.C. § 5221(e) (2012); American Recovery and Reinvestment Act of 2009, Pub. L. No. 111-5, § 111(e), 123 Stat. 115, 519 (2009). About 280 financial firms that received TARP funds were required to hold say-on-pay votes. Thomas et al., *Dodd-Frank's Say on Pay*, supra note 16, at 1223.

108. *See* FIN. CRISIS INQUIRY COMM'N, THE FINANCIAL CRISIS INQUIRY REPORT: FINAL REPORT OF THE NATIONAL COMMISSION ON THE CAUSES OF THE FINANCIAL AND ECONOMIC CRISIS IN THE UNITED STATES 83–402 (2011) (detailing the history of the financial crisis).

109. *See* Andrews & Baker, *supra* note 43.

110. *See* Mark J. Roe, *Delaware's Competition*, 117 HARV. L. REV. 588, 600–32 (2003) (arguing that the federal government intervenes in corporate governance when it perceives failures or inadequacies in state corporation laws); *see also* Mark J. Roe, *A Spatial Representation of Delaware-Washington Interaction in Corporate Lawmaking*, 2012 COLUM. BUS. L. REV. 553 (2012).

111. Thomas et al., *Dodd-Frank's Say on Pay*, *supra* note 16, at 1218.

112. Dodd-Frank Wall Street Reform and Consumer Protection Act, Pub. L. No. 111-203, § 951, 124 Stat. 1376, 1899–1900 (2010) (codified at 15 U.S.C. § 78n-1(a)(1) (2012)). The disclosure of executive compensation is provided in 17 C.F.R. § 229.402 (2015).

payments in a merger or acquisition.[113] In spite of management recommendations for triennial votes, shareholders of most companies have voted to hold say-on-pay votes annually.[114] Shareholder votes apply to the compensation packages of the top five executive officers named in the proxy compensation disclosure.[115] The vote is a straight "for" or "against" the overall compensation package and does not provide for line-item voting.[116] The vote is advisory and not binding on the board.[117] Say-on-pay does not create or imply any change to the fiduciary duties of the board or create any additional fiduciary duties.[118] The authority to approve compensation packages still rests squarely with the board.

The Dodd-Frank Act strengthened the board's independence from the influence of insider executives regarding pay decisions because the board must consider the advice of shareholders. Public companies must have independent board members on its compensation committee.[119] Relevant factors in determining independence are the source of compensation of a director, and whether a director is affiliated with the company or its affiliates.[120]

The Dodd-Frank Act also recognizes the political and socio-economic dimensions of relative pay and income inequity. It requires disclosure of the median of the annual total compensation of all employees (excluding the CEO), the annual total compensation of the CEO, and the ratio of the two figures.[121] Since CEO pay is already required to be disclosed, the important disclosure is the median employee pay. The ratio succinctly communicates pay differential. This increased disclosure is required in any annual report, proxy or information statement, or registration statement that requires

113. 15 U.S.C. § 78n-1(a)(2), (b).

114. Thomas et al., *Dodd-Frank's Say on Pay*, supra note 16, at 1249.

115. 17 C.F.R. § 240.14a-21(a) (2011).

116. *Id.*

117. 15 U.S.C. § 78n-1(c).

118. *Id.*

119. *See supra* note 87.

120. Dodd-Frank Wall Street Reform and Consumer Protection Act, Pub. L. No. 111-203, § 952, 124 Stat. 1376, 1900–03 (2010); *see* N.Y.S.E *supra* note 87, at § 303A.02(a)(ii) (providing the test of independence as "all factors specifically relevant to determining whether a director has a relationship to the listed company which is material to that director's ability to be independent from management in connection with the duties of a compensation committee member").

121. Dodd-Frank Act § 953(b). The SEC adopted the rule for pay ratio disclosure. Pay Ratio Disclosure, Exchange Act Release Nos. 33-9877, 34-75610, 17 C.F.R. Pts. 229, 249, at 1–2 (effective date Oct. 19, 2015), http://www.sec.gov/rules/final/2015/33-9877.pdf [perma.cc/ET5F-DVGL] [hereinafter Pay Ratio Disclosure].

executive compensation disclosure.[122] The wage ratio disclosure is a legislative nod to the concerns of employees and the public.

The pay ratio disclosure may result in several benefits. Shaming may temper the most pecuniary appetites, though there is the distinct possibility that millions of more dollars may ultimately outweigh the cost of these negative feelings. CEOs may also feel pressure from the public disclosure. Although CEOs are public figures, many would prefer to avoid notoriety in the eyes of the public. An eye-catching disparity in pay may depress employee morale and elicit disapproval, which are relevant to the production function of the company. Boards might also be sensitive to these kinds of pressures. These combined effects may influence pay practices at the margins. The pay ratio disclosure could be a small step toward greater equity in compensation.

D. Limits of Shareholder Monitoring

Even before the widespread implementation of the Dodd-Frank Act, commentators were skeptical of the effectiveness of shareholder voting to curb excessive executive compensation after examining prior experience abroad.[123] Recent empirical studies have generally supported this prediction.[124] According to one study, shareholders strongly supported management resolutions on pay.[125] Votes in favor averaged 91.2% for all companies.[126] Only 37 companies failed to receive majority support.[127] These negative votes stemmed from shareholder discontent arising from a perceived disconnect between pay and company performance.[128] Overall, shareholder votes were highly correlated with share price returns and the amount of CEO pay:

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122. The SEC recently issued proposed rules on implementing Section 953(b). Pay Ratio Disclosure, *supra* note 121, at 15–25.

123. *See* Jeffrey N. Gordon, *"Say on Pay": Cautionary Notes on the U.K. Experience and the Case for Shareholder Opt-In*, 46 HARV. J. ON LEGIS. 323, 341 (2009) (noting that in the U.K. shareholders approved compensation packages in many thousands of votes with only eight negative votes over a six-year period).

124. *See generally* Thomas et al., *Dodd-Frank's Say on Pay*, *supra* note 16 (providing preliminary empirical data on voting results); Thomas et al., *First Year*, *supra* note 16 (same).

125. In the 2011 proxy season, about 2,220 U.S. public companies held shareholder votes on executive compensation. Thomas et al., *Dodd-Frank's Say on Pay*, *supra* note 16, at 1248.

126. Thomas et al., *Dodd-Frank's Say on Pay*, *supra* note 16, at 1248, report similar results from other empirical studies. *See* Michael Littenberg, Farzad Damania & Justin Neidig, *A Closer Look at Negative Say-on-Pay Votes During the 2011 Proxy Season*, DIRECTOR NOTES (Conference Bd.), July 2011, at 2 (noting that only 36 companies, or 1.6%, of 2225 companies in the Russell 3000 that held votes rejected management compensation resolutions). About 71% of companies received more than 90% shareholder vote, 23% received 70–90% vote, and 6% received 50–70% vote. Thomas et al., *Dodd-Frank's Say on Pay*, *supra* note 16, at 1250.

127. Thomas et al., *Dodd-Frank's Say on Pay*, *supra* note 16, at 1251.

128. *Id.*

Shareholders favored high share returns and low CEO pay, and disliked low share returns and high pay; and their voting patterns reflected these preferences.[129] Shareholders did not necessarily follow the recommendations of Institutional Shareholder Services (ISS), a proxy advisory firm.[130] While all 37 negative votes followed the negative recommendations of ISS, the firm recommended negative votes for 285 total companies, 13% of the companies it reviewed.[131]

In light of the pattern of positive votes, "the voting gesture mandated by law might have been mostly empty."[132] However, the legal right to a voice on the issue may have changed the dialogue dynamic between shareholders and management.[133] In a few cases, management has been responsive to some aspects of shareholder concern.[134] These marginal effects of shareholder voting—generally the limit of shareholder efficacy in monitoring—are not surprising. Commentators have previously predicted that say-on-pay would be ineffective because shareholders will not engage in individualized analysis and monitoring of executive compensation.[135] Preliminary data seem to support, in the main, these earlier critiques.

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129. *Id.* at 1249. Given these preferences, shareholders tended to vote no more in a situation where share price declined but the CEO was highly paid. *Id.*

130. ISS provides proxy services to shareholders for a fee, and provides proxy voting recommendations. *See* INST. S'HOLDER SERVS. INC. http://www.issgovernance.com (last visited Jan. 20, 2016) [perma.cc/25DN-HJSU].

131. Thomas et al., *Dodd-Frank's Say on Pay*, *supra* note 16, at 1255; *see* John Helyar, *After Much Hoopla, Investor 'Say on Pay' Is a Bust*, BLOOMBERG BUSINESSWEEK, June 20, 2011, at 23 (reporting that ISS advised shareholders to vote no on 293 companies, but only 32 companies actually received negative votes). However, ISS still had some influence. In another study, Thomas, Palmiter and Cotter report that when ISS recommended "for" votes, shareholders voted in favor on average 92.6% with no proposals being voted down. When ISS recommended "against" votes, shareholders voted in favor 64.4%, with 31 failed votes out of 173 "against" recommendations. Thomas et al., *First Year*, *supra* note 16, at 983; *see* Kang, *supra* note 18, at 1334:

> The fact that shareholders might rely on a heuristic voting cue from the endorsement of proxy advisors is utterly unsurprising. Voters in similar large-scale electorates regularly rely on heuristic cue-taking from credible agents who are perceived to have the same values and can be reasonably trusted to offer the recommendations that the voter would have reached with the investment of time and thought.

132. Thomas et al., *Dodd-Frank's Say on Pay*, *supra* note 16, at 1265.

133. *Id.*; *see* Thomas et al., *First Year*, *supra* note 16, at 1002–10 (providing four case studies of the dialogue between shareholders and management resulting from shareholder votes on executive compensation).

134. *See* Thomas et al., *Dodd-Frank's Say on Pay*, *supra* note 16, at 1265; *see also* Thomas et al., *First Year*, *supra* note 16, at 1002–10. Some empirical studies have suggested that say-on-pay has not changed the amount of compensation, but instead it changed the mix of cash and incentive pay. *See* Natasha Burns & Kristina Minnick, *Does Say-on-Pay Matter? Evidence from Say-on-Pay Proposals in the United States*, 48 FIN. REV. 233, 246–51 (2013) (using examples from the U.K.).

135. *See* Gordon, *supra* note 123, at 341.

The problem with shareholder say-on-pay is the well-recognized observation of rational shareholder apathy.[136] "Often the aggregate cost to shareholders of informing themselves of potential corporate actions, independently assessing the wisdom of such actions, and casting their votes will greatly exceed the expected or actual benefits garnered from informed voting."[137] Apathy toward monitoring is rational from an individual cost-benefit perspective. The problem is one of collective action.[138] It is exacerbated when diffuse shareholders hold diversified portfolios,[139] and when the turnover on the typical investment is relatively short, even for long-term shareholders.[140] The profile of the shareholder with the most incentive to monitor corporate governance is the long-term, activist, or undiversified shareholder. However, such shareholders are not ubiquitous in a modern, liquid equity market in which diversification is said to be a good thing.[141] Lastly, as the efficient market hypothesis suggests, many shareholders rely on market prices to incorporate all public information, which further diminishes the incentive to monitor investments at the individual holding level.[142]

Evidence from both the U.K. and the U.S. supports the hypothesis of shareholder apathy in voting.[143] Most shareholders vote in favor of management's compensation the majority of the time. For a company that has not disappointed shareholders with lower returns or incited their discontent with excessively high executive compensation

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136. *See* CLARK, *supra* note 18, at 390–400 (discussing the problem of the rationally apathetic shareholder).

137. *Id.* at 390–91.

138. *Id.* at 391–92. Given the typical shareholder's minority holding, shareholders do not have an incentive to incur the significant cost of active monitoring, which would yield insufficient return to the shareholder given the cost.

139. *See* Harry Markowitz, *Portfolio Selection*, 7 J. FIN. 77, 79 (1952) (advancing portfolio theory of stock investment).

140. *See* Mark Roe, *Are Stock Markets Really Becoming More Short Term?*, PROJECT SYNDICATE (Feb. 21, 2013), http://www.project-syndicate.org/commentary/has-short-termism-in-stock-markets-increased-by-mark-roe (the average hold period for longterm investors like Fidelity and Vanguard was a year and a half in 2010).

141. *See* Markowitz, *supra* note 139, at 77 (showing that diversification can be a normatively good investment strategy).

142. *See* BREALEY ET AL., *supra* note 45, at 327 ("The evidence on efficient markets has convinced many professional and individual investors to give up pursuit of superior performance. They simply 'buy the index,' which maximizes diversification and cuts costs to the bone."); *see also* Halliburton Co. v. Erica P. John Fund, Inc., 134 S. Ct. 2398 (2014); Basic, Inc. v. Levinson, 485 U.S. 224 (1988).

143. *See* KYM MAREE SHEEHAN, THE REGULATION OF EXECUTIVE COMPENSATION: GREED, ACCOUNTABILITY AND SAY ON PAY 145–59 (2012) (discussing the limits of institutional investors as effective monitors of executive pay).

for poor performance,[144] the default vote would likely be in favor of the compensation package. Even when a proxy advisory firm issues a negative recommendation, shareholders mostly disregard the advice.[145]

A contrary interpretation of the preliminary data is that shareholders are fully engaged in monitoring compensation, and in the vast majority of cases voted in favor of compensation packages after informed consideration. Empirical data on voting outcomes do not reveal the thought processes of the many thousands of voting shareholders. One wonders whether shareholders examined the record and made individualized informed decisions for companies in their diversified portfolios.[146] The conclusion to be inferred from mostly positive votes is important. A hypothesis of shareholder informed decision-making would be far-reaching. It implies that there has not been a real problem of executive compensation at all, and that informed shareholders agree with most pay packages; the many critiques of executive compensation would therefore be simply much ado about nothing, since they do not reflect the concerns of most shareholders. However, this inference from the data has not been demonstrated to be true,[147] and most scholars have not advanced it.

Even institutional shareholders are not immune from apathy because as highly diversified, active traders in a liquid equity market, the cost-benefit analysis of active involvement is acute. Although proxy advisers could ameliorate the collective action problem,[148] the preliminary empirical evidence suggests that this is not the case.[149] If say-on-pay is limited in its efficacy, it reflects the fact that shareholders are limited in their capability to effectively monitor.[150] Shareholders are limited to market information, primarily share price returns and publicly disclosed financial results, explaining the relationship between the level of voting support and share price. There is a need for more

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144. *See* Thomas et al., *Dodd-Frank's Say on Pay*, *supra* note 16, at 1249 (reporting that "low returns and high CEO pay result[ed] in lower say-on-pay support").

145. *See id.* at 1265 ("ISS may be less influential than commonly thought on this type of proposal.").

146. *See* Kang, *supra* note 18, at 1313 ("At least for such public companies with dispersed ownership, it is highly unlikely that the multiplicity of shareholders will remain well informed about the company's affairs and then achieve collective agreement on the best course of action for their company.").

147. *See supra* notes 50–51 and accompanying text.

148. *See* Gordon, *supra* note 123, at 351–52.

149. *See* Thomas et al., *Dodd-Frank's Say on Pay*, *supra* note 16, at 1213 (noting that "the net effect of a negative ISS recommendation on the overall shareholder vote is relatively small at most companies").

150. *See* Adams, *supra* note 18, at 422 (noting that "shareholders have historically been of little importance in monitoring corporate conduct" due to "the collective action problem").

monitoring of executive compensation than just the efforts of shareholders.

II. INTRAFIRM MONITORING

A. Employee Advisory Vote

In light of the known limitations of shareholder say-on-pay, this Article proposes the utility of additional monitors of pay. Employees can serve as intrafirm monitors of executive compensation, and the means to do this have already been considered and implemented into law.[151] The structure can mirror the Dodd-Frank Act's mandate of shareholder say-on-pay. At least once every 3 years, a public U.S. corporation should hold an employee vote to approve the compensation of top executives.[152] Unison of voting between shareholders and employees should not be required, as long as employees have periodic opportunities to vote and convey information to the board. However, it would be ideal if shareholders and employees voted in tandem. Most shareholder votes occur annually, and so employee votes should follow the same schedule.

Shareholder say-on-pay is an advisory vote, not binding on the board.[153] The Dodd-Frank Act mandates that the shareholder vote cannot be construed: "(1) as overruling a decision by such issuer or board of directors; (2) to create or imply any change to the fiduciary duties of such issuer or board of directors; (3) to create or imply any additional fiduciary duties for such issuer or board of directors."[154] This provision recognizes that, under state corporate law, the board has the ultimate authority to manage the business and affairs of the corporation, including setting compensation. The same limitation should also apply to employee voting.

Employee voting could be further limited by conditioning it on a wage-ratio trigger. The Dodd-Frank Act requires the disclosure of the wage ratio between the CEO and employees.[155] Employee say-on-pay could be structured to trigger upon the company exceeding a certain

151. *See* Dau-Schmidt, *supra* note 25, at 802 (suggesting an "alliance between capital and labor in monitoring management" and that this "lack of the appearance of this alliance in American corporate governance is an important cause of our problem with excessive management compensation").

152. *Cf.* Dodd-Frank Wall Street Reform and Consumer Protection Act, Pub. L. No. 111-203, § 951, 124 Stat. 1376, 1899–1900 (2010) (instituting similar provisions).

153. *Id.*

154. *Id.*

155. Dodd-Frank Act § 953. The SEC has announced proposed rules on wage ratio disclosure. *See* Pay Ratio Disclosure, *supra* note 121.

level of wage ratio. However, there is an efficiency consideration. The concept of say-on-pay is a response to *excessive* compensation. A certain level of wage ratio could be deemed presumptively not excessive when compared to the baseline of the median employee pay. For example, if the compensation ratio is 20:1—a quaint level in light of the modern trend in compensation—one would question whether a say-on-pay vote by either shareholders or employees is really necessary.

Certain intuitions can guide us. A trigger of 20:1 would most likely be deemed too low, and would take executive compensation back to the 1960s and 1970s.[156] A trigger of 100:1 would probably be too high because this level is in the neighborhood of current levels that have caused public and political rebuke.[157] Some compromise in the range between 50:1 and 100:1 seems intuitively appropriate (but, of course, these would be matters of legislative determination). This range permits high salary, but one suspects that neither employees nor the public would be so outraged by this sort of level. Any rent extraction that may occur would be fairly marginal, and properly deemed insignificant in light of the cost of monitoring.[158]

A concrete example illustrates the point. Suppose the median employee pay at a corporation is $50,000.[159] At a trigger range of 75:1, CEO pay could be $3.75 million without triggering employee say-on-pay. Based on current pay levels of CEOs today, the majority of public companies—most of which are, by definition, small to medium capitalization companies—may not be required to hold employee votes.[160] Since the size of CEO pay is highly correlated with the size of

156. To be clear, the suggestion that it is "too low" refers to the necessary political compromises that have to take place to enact legislation. By way of comparison, the Japanese ratio of CEO to average employee pay is approximately 16:1. Jason Clenfield, *In Japan, Underpaid—and Loving It*, BLOOMBERG BUSINESSWEEK (July 1, 2010), http://www.businessweek.com/magazine/content/10_28/b4186014341924.htm [https://perma.cc/RGE9-PTFG].

157. *See supra* note 39 and accompanying table.

158. *See* Carola Frydman & Dirk Jenter, *CEO Compensation* 20 (Nat'l Bureau of Econ. Research, Working Paper No. 165, 2010) ("Moreover, 'awarding' pay by allowing managers to extract some rents can be optimal if monitoring is costly."), http://www.nber.org/papers/w16585.pdf [https://perma.cc/9A9K-TR5A].

159. *See id.* at 41 (providing average nonsupervisory worker compensation). Some companies pay their employees high compensation. *See, e.g.,* Brett Philbin, *Average Goldman Pay: $399,506*, WALL ST. J. (Jan. 13, 2013) (noting the average pay at Goldman Sachs in 2012), http://www.wsj.com/articles/SB10001424127887323968304578245482333171010 [https://perma.cc/38SG-PUQG]; Gus Lubin, *Google Has the Highest Average Salaries in the Tech Industry: $141,000*, BUSINESS INSIDER (June 10, 2011) (noting the average pay at Google in 2010), http://www.businessinsider.com/google-really-is-the-best-tech-company-to-work-for-2011-6 [https://perma.cc/X5HT-R89B].

160. In 2011, the median total realized compensation of CEOs in the Russell 2000 was $1.84 million. *2012 Preliminary Pay Survey: Two Consecutive Years of Double-Digit Pay Increases*, GMI

the corporation,[161] the compensation packages for the largest companies would more likely be subject to employee say-on-pay.[162]

Additionally, the idea of a wage trigger can be applied to shareholder say-on-pay as a tweak of the Dodd-Frank reform. Shareholder voting, one can argue, would be unnecessary if the wage ratio between the CEO and employees did not exceed a certain level. This reform of say-on-pay could have efficiency benefits. One strongly suspects that in light of the correlation between firm size and pay, a significant portion of smaller companies,[163] perhaps even a majority, would be exempt from holding say-on-pay votes with a reasonable trigger, and that many larger companies would still be subject to shareholder vote. One hastens to add that if the idea is appealing in the abstract, the difficulty in practice would be to identify the trigger level. A trigger in the range between 50:1 to 100:1 seems plausible as a political compromise of the legislative process.

B. Weighed Voting

The idea of employee voting requires a further analysis of how voting should be implemented. Of course, there is a fundamental difference between political voting and voting in corporations. Notwithstanding the rhetoric of shareholder democracy,[164] a

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RATINGS 3 (2012), http://origin.library.constantcontact.com/download/get/file/1102561686275-128/GMIRatings_PrelimPaySurvey2012_052012.pdf [https://perma.cc/2BCV-HGPQ] (based on a sample size of 1349 companies).

161. *See id.* at 2 (showing significant pay differences among CEOs in the S&P Smallcaps, Midcaps, and 500 indices, with 2011 median total realized compensations of $2.57 million, $4.74 million, and $8.79 million, respectively).

162. *See id.* at 4 (showing a median total realized compensation of $11.9 million in 2012 for CEOs of Fortune 500 companies); Gretchen Morgenson, *The Unstoppable Climb in C.E.O. Pay*, N.Y. TIMES, June 29, 2013, at BU1 (noting that the top 100 CEOs were paid a median compensation of $14 million in 2012).

163. The SEC provided an exemption from say-on-pay to smaller companies with less than $75 million in public float until January 20, 2013. Shareholder Approval of Executive Compensation and Golden Parachute Compensation, 76 Fed. Reg. 6010, 6010 (Feb. 2, 2011). Smaller reporting companies must now hold say-on-pay votes.

164. Shareholder democracy is frequently used as shorthand for shareholder participation through voting in corporate governance. *See* Schnell v. Chris-Craft Indus., Inc., 285 A.2d 437, 439 (Del. 1971) (referring to the principle of shareholder voting as "corporate democracy"); Hoschett v. TSI Int'l Software, Ltd., 683 A.2d 43, 45–46 (Del. Ch. 1996) (Allen, C.) (noting that voting and deliberation aspects of shareholders' annual meeting resembles democratic discourse); Bebchuk, *Shareholder Power*, *supra* note 56, at 842–43 (suggesting that shareholder democracy will enhance shareholder value); *see also* Lisa M. Fairfax, *Making the Corporation Safe for Shareholder Democracy*, 69 OHIO ST. L.J. 53, 55 (2008) (suggesting a link between shareholder democracy and corporate and executive accountability).

corporation is not a platonic political entity.[165] It is an economic organization. There is no liberty interest in the right to governance. There is not even a property or vested contract interest in the rights stated in stock.[166] The political principles of universal suffrage and "one person, one vote"[167] do not apply for obvious reasons.[168] Shareholder voting is based on shares owned,[169] and shareholder classes of unequal rights are permissible.[170]

Voting rights in corporations serve an economic purpose.[171] Unlike shareholders, employees and creditors typically do not vote on

165. *See Hoschett*, 683 A.2d at 45–46 (noting that "the model of democratic forms should not too strictly be applied to the economic institution of a business corporation (where for instance votes are weighted by the size of the voter's investment)"); *see also* Tom C.W. Lin, *CEOs and Presidents*, 47 U.C. DAVIS L. REV. 1351, 1398 (2014) (suggesting that "[c]orporations are not democratic nation-states" and that wholesale attempts to "democratize" them can cause serious harms).

166. *See* Fed. United Corp. v. Havender, 11 A.2d 331 (Del. 1940):

> Consequently, in a case where a merger of corporations is permitted by the law and is accomplished in accordance with the law, the holder of cumulative preference stock as to which dividends have accumulated may not insist that his right to the dividends is a fixed contractual right in the nature of a debt, in that sense vested and, therefore, secure against attack. . . . On the contrary, his contract has informed him that the right is defeasible; and with that knowledge the stock was acquired.;

id. at 339; *see also* Bove v. Cmty. Hotel Corp., 249 A.2d 89, 96 (R.I. 1969) (holding that "any subsequent legislation enacted pursuant to [a corporation statute's reservation clause], even though it may amend the contract's original terms, will not impair its obligation in the constitutional sense").

167. *See* Baker v. Carr, 369 U.S. 186, 208 (1962) (recognizing a "citizen's right to a vote free of arbitrary impairment by state action . . . when such impairment result[s] from dilution").

168. *See* Robert B. Thompson & Paul H. Edelman, *Corporate Voting*, 62 VAND. L. REV. 129, 158–59 (2009) (discussing voting a matter of shares held and the quantities of votes entitled in each share). On the other hand, the default rule of partnership provides for a "one partner, one vote." *See* UNIF. P'SHIP ACT § 401(f) (NAT'L CONFERENCE OF COMM'RS ON UNIF. STATE LAWS 1997) ("Each partner has equal rights in the management and conduct of the partnership business.").

169. *See* CLARK, *supra* note 18, at 390 ("We could argue further that voting rights should be proportional to one's share of the residual interest in the firm."). This is not the case in other business organizations such as partnerships. *See* UNIF. P'SHIP ACT § 401(f) ("Each partner has equal rights in the management and conduct of the partnership business."). More generally, inequality and inequity are separate concepts in corporation law. *See* Applebaum v. Avaya, Inc., 812 A.2d 880, 886 (Del. 2002) (noting that "equity and equality are not synonymous concepts in the Delaware General Corporation Law"); Nixon v. Blackwell*,* 626 A.2d 1366, 1376 (Del. 1993) ("It is well established in our jurisprudence that stockholders need not always be treated equally for all purposes.").

170. *See* DEL. CODE ANN. tit. 8 § 151(a) (2015) (permitting different preference rights and classes of stock). Companies like Google, Berkshire Hathaway, and Ford Motor have different classes of common stock with different voting rights.

171. *See* FRANK EASTERBROOK & DANIEL R. FISCHEL, THE ECONOMIC STRUCTURE OF CORPORATE LAW 63–89 (1996) (explaining the importance of voting rights of equity capital); Thompson & Edelman, *supra* note 168, at 130 (arguing that shareholder voting right is a means of error correction).

important governance matters.[172] These observations raise a question of how the voting scheme should be structured. This Article proposes that every employee should have a vote, but that vote allocation should be unequal. Vote allocation should be a function of the potential effectiveness of different classes of employees as monitors of executive performance.

Even the lowest ranking employee of a large public company may have some sense of how the company is doing. But their understanding of CEO performance would not compare to the senior manager of a business unit within a corporation. Consider a low level worker at a large corporation with a market capitalization of $10 billion. How will the lowest rank and file employee, who may earn $25,000 per year for a low skill job, feel about the CEO earning $10 million, a ratio of 400:1? Would the employee's likely visceral reaction to the income disparity be relevant? These kinds of anticipated personal reactions at the firm level should not be factors in determining executive compensation. The best way to control for this is through weighed voting.

The allocation of voting rights should be based on employee titles, functions, and job descriptions. Employee say-on-pay must principally serve a monitoring role.[173] This function requires informed voting, which communicates relevant information to the board. In rational corporate hierarchies, the quantity and quality of information held is fairly correlated to position in the corporate hierarchy.

Companies should have discretion to allocate votes, subject to a prohibition against gaming. Gaming is achieved by allocating the most voting power to the highest level of executive management, since this level would most favor executive pay proposals.[174] There is a balance between calibrated voting and gamed outcomes. This balance can be achieved either through the use of qualitative standards, or through bright-line quantitative rules.[175]

For example, a proportion that allocates 10% of the vote to the non-managerial rank and file employees, who constitute 90% of the

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172. *See* MODEL BUS. CORP. ACT § 7.21(a) (1969) (AM. BAR ASS'N, amended 2010) ("Only shares are entitled to vote."); *cf.* DEL. CODE ANN. tit. 8 § 221 (2015) (permitting debt instruments to have voting rights). Absent unusual circumstances, however, it would be odd for debt instruments to have voting rights. Eliasen v. Itel Corp., 82 F.3d 731, 732–38 (7th Cir. 1986) (Posner, J.).

173. *See* Adams, *supra* note 18, at 442 (noting that full-circle evaluations promote "efficiency and profitability").

174. *See infra* Section II.C (discussing the possibilities of gamed outcomes and the means to prevent them).

175. *See* Louis Kaplow, *Rules Versus Standards: An Economic Analysis*, 42 DUKE L.J. 557, 557–623 (1992) (analyzing the difference between rules and standards and their best application).

corporation's workforce, might not be an unreasonable mix. This allotment is a significant but nonetheless minority voting power. The visceral reaction of the average employee against a relatively high CEO pay, if that is the fear, would not overwhelm the voting outcome. At the same time, knowing what average employees think about their CEO's pay is still relevant information for the board. Issues like morale, happiness, job satisfaction, commitment to the firm, social cohesion, and sense of common undertaking (if not common lot) are important to the business; and they are relevant factors in the corporation's production function. A small but meaningful allocation can serve a role in providing a mix of information. Each company should be allowed to calibrate voting such that there can be meaningful participation.

The class of voters with the greatest individual voting power should be the managerial ranks—the ranks below the highest executive level subject to Securities and Exchange Commission ("SEC") compensation reporting requirements. For definitional clarity, "senior and middle managers" hereafter refers to all other officers, executives, and managers outside of the top "senior executive officers," such as the CEO and the CFO. Below the senior executive officers, there is a significant class of senior managers who manage large business units or functions. They possess the best information on the performance of the CEO and the company's prospects, but they are most likely to be biased in favor of the CEO. These competing tensions balance such that they have the greatest *individual* voting power, but not *class* voting power. Class voting power is limited by the pyramidal organizational structure where more senior ranks are fewer in number.

There are compelling reasons to argue that the class of voters with the greatest voice should be the senior and middle managers,[176] the layers below the top five senior executive officers whose pay packages are subject to vote.[177] This group is large in most significant corporate enterprises. They connect the shop floor with the executive suite. They have management responsibilities, tasked with executing the strategies given down from above. They have broad organizational awareness, and a good sense of connecting corporate strategy with tactical understanding. They dream of climbing higher in the corporate hierarchy, high enough to earn the keys to the executive suites; yet they are not so far removed from the bottom tier to have lost a sense of economic proportion. They report directly to senior executive officers, and the managerial rank exchanges vital information. They are in

176. "Midlevel management knows how well the company is functioning on a daily basis and which parts of the company's structure needs additional work." Adams, *supra* note 18, at 432.

177. 17 C.F.R. § 240.14a-21(a) (2012).

routine contact with outside constituencies such as suppliers and customers. They are important inputs for gauging morale, and for influencing broader rank and file morale.

Senior and middle managers collectively know much about the state of the corporation, its trajectory, and the cause and effect of corporate leadership on firm performance, and in many cases they collectively know more than their individual superiors. Many or most have invested significant human capital in long careers at the company. They are professionally, economically, and personally vested in the success of the corporation; and while they can exit their professional investments at any given time, such exit is not as frictionless as the available exit of public shareholders. Their commitments are longer term and less diversified; thus they have a significant personal stake in the performance of the corporation. They are the leaders in the trenches of the firm. Their collective opinions should not be underestimated even at the rarified board level, though as a practical matter it is difficult for boards to get direct information from them.

While the non-managerial employee who earns $25,000 in a low-skill position may not be an informed voter in important respects, the same cannot be said for the $250,000 non-executive vice president responsible for a market segment, a product, or client base. Such a person would have significant information on the state of the company, how the senior executives are managing it, and ultimately the performance of the CEO. Furthermore, the class of vice presidents on the same level would hold a substantial quantity and quality of the firm's total information.

Based on the foregoing reasons, a stylized example of a voting allocation might look something like this: 10% to the general workforce, 60% to middle and senior nonexecutive managers, and 30% to other executive officers. In most companies with a pyramid organizational structure, the general workforce would, by definition, constitute most of the employees. Conceptually, the voting allocation should be a reverse pyramid. In this allocation scheme, 90% of the voting power is allocated to the small minority in the managerial ranks. The proposal here is not based on some vague or misguided notion of corporate egalitarianism. It is a proposal designed to elicit information from all employees but mostly from a broader managerial rank than the board normally works with in performing its monitoring function. Lastly, I note that there is no "correct" proportion in some deductive sense, but a range of reasonable voting allocations that credibly serve the principal function.

C. Gamed Voting

Whenever there is consequential voting, there lurks a potential problem of gaming. There are two kinds of gaming problems in the proposed allocation scheme. The first is where management allocates votes in such a way as to stack the deck in favor of the CEO. This is structural gaming—the senior management (whose compensation is subject to vote) manipulates the structure of the scheme to rig the outcome. The second is internal gaming where the employee's internal self-interested motivations affect the voting. These gaming effects are related.

Confidentiality in voting is important since retaliation can be a real risk in employment contexts,[178] particularly in the senior ranks. An employee may rationally fear that confidentiality is not assured. Ordinary employees would have less to fear. Would a CEO fire some random assembly line worker in a far-flung operation due to a negative vote (assuming that such a vote was even traceable)? However, such fear would be more grounded in reality for the senior and managerial ranks, but these employees are also important sources of information.

Confidentiality can be breached through deductive analysis of voting outcomes if voting allocation is structurally gamed. While it would be impossible for anyone to know how a specific low-level employee voted based on voting results, deductive analysis can reveal the votes or voting patterns of employees with significant voting power.

Simple numeric examples illustrate the relationship between confidentiality, gamed voting, and probabilistic inference. Suppose there are four classes of employees below the top executives whose compensations are subject to board approval and public disclosure. The corporate hierarchy has four levels outside of the top senior executive officers: class A is the senior executives, class B senior nonexecutive managers, class C middle managers, and class D the general workforce. The class voting allocations are: 20% (A), 28% (B), 30% (C), and 22% (D). Each class has the following number of employees and votes.

178. *See* Adams, *supra* note 18, at 431, 437 (stressing the importance of anonymity in full-circle evaluations where subordinates are evaluating supervisors); *see also* Lyrissa Barnett Lidsky & Thomas F. Cotter, *Authorship, Audiences, and Anonymous Speech*, 82 NOTRE DAME L. REV. 1537, 1570–71 (2007) (discussing the importance of confidentiality in employment and whistleblower contexts); Benjamin I. Sachs, *Enabling Employee Choice: A Structural Approach to the Rules of Union Organizing*, 123 HARV. L. REV. 655, 706–12 (2010) (discussing the need for confidentiality and secrecy in union organizing).

Employee Class	Number of Employees	Votes per Individual	Individual Voting Power	Votes per Class	Class Voting Power
A	1	10	20%	10	20%
B	2	7	14%	14	28%
C	5	3	6%	15	30%
D	11	1	2%	11	22%
Total	19	na	na	50	100%

Suppose the compensation package was voted down with thirty "against" votes, which totaled 60% of all votes. It is impossible to know how the lower level employees voted, and from the CEO's perspective, she may not care as much. The CEO works most closely with the executives and senior managers—the three employees in classes A and B. Since these three hold twenty-four votes, it is a mathematical certainty that at least one of them voted "against." Also, it is unlikely that only one voted "against." If the class A employee voted "against" (ten votes), then the remaining twenty "against" votes must have come from the collective twenty-six votes held at classes C and D, which is perhaps an unlikely 77% majority of the lower two classes. If the one negative vote was from a class B employee (seven votes), then the remaining 23 "against" votes must have come from the 26 votes at classes C and D, which is a highly unlikely 88% majority of the lower two classes. These outcomes are plausible, but in varying degrees of probability unlikely absent special reasons why a large segment of one class or another would caste negative votes. A CEO can be confident that the most likely possibility is that two of the three employees in classes A and B—those employees who are the closest to her—voted "against." If the CEO had other information as well—for example, past dealings, personal relationships, and emotional intuitions—the identities of the "against" voters could be fairly obvious. By voting "against," these employees could harm their career prospects. A CEO who correctly perceives that a majority of her management team does not have confidence in her can easily solve the problem by replacing them. Thus, under this voting structure, higher-class employees would have incentive to internally game the vote irrespective of their opinions on the company's prospects and the CEO's performance.

Such deductive reasoning quickly loses efficacy when the voting permutations increase due to greater number of voters and decreased concentration of voting powers. As the saying goes, there is safety in numbers: probability theory says that increasing the number of voters would obscure voting identity.

Consider a more complex organization with the identical voting allocations by employee rank. The class voting allocations are the same as above: 20% (A), 28% (B), 30% (C), and 22% (D). But there are now more employees and thus each employee's voting power has been diluted significantly.

Employee Class	Number of Employees	Votes per Individual	Individual Voting Power	Votes per Class	Class Voting Power
A	2	10	10%	20	20%
B	4	7	7%	28	28%
C	6	5	5%	30	30%
D	22	1	1%	22	22%
Total	34	na	na	100	100%

Suppose again that there are 60% "against" votes constituting 60 individual votes. It is not clear what combination of voters produced the 60% outcome. Some combination of six employees at classes A and B must have voted no, but it is unclear who they may be. Again, intuitions and insights from personal dealings may shed some light, but the conclusions may be far less reliable. Much of the deductive reasoning power loses efficacy when votes become confidential due to the ability to hide in numbers.

These simple examples can be generalized to the situations at corporations of various sizes. They show that, once the number of employees is scaled up to the size of public companies (even small capitalization companies), gaming is difficult due to the increased number of voters.

Probabilistic outcomes increase nonlinearly with each additional employee.[179] For a public company with an employee headcount that is greater than the simple numbers used in these example, the possible permutations of voting combinations are too many to make accurate inferences for a senior executive officer to take retaliatory action or otherwise wrongfully influence voting outcomes so long as the allocation is not gamed. In larger corporations (which tend to be public companies), the problem of voting transparency is not so significant.

179. The mathematical principle of factorial (mathematical notation $n!$) is helpful to understand the nonlinear increase in probabilistic outcomes. *See* JOHN E. FREUND, INTRODUCTION TO PROBABILITY 14–18 (1973) (discussing permutations and factorials). The factorial function calculates the number of potential combinations or permutations of a set of objects. For example, for the set {A, B, C} the factorial is calculated as: 3! = 3 x 2 x 1 = 6. This means that there are 6 combinations of the set {A, B, C}, which are: ABC, ACB, BAC, BCA, CAB, CBA. The number of combinations increase nonlinearly with each integer increase in a factorial. The factorial of 4! = 24, but 5! = 120.

These simple examples show several possibilities of gaming. The structure of the scheme can be rigged: *i.e.*, giving the employees most likely to vote positively the most number of votes. Gaming can also be internally influenced: *i.e.*, employees voting strategically for self-interested reasons, which affect the highest executive level employees the most. If there is a likelihood of discovery, employees would self-game the voting to avoid punishment or to curry favor.

D. Implementation

Despite the framework based on shareholder say-on-pay, several issues are unique to employee voting. The problems are conceptualizing the corporate hierarchy for the purpose of vote allocation, the right to vote for foreign employees, and the actual mechanics of voting.

First, corporations have organizational charts and are defined by a hierarchical system of titles, functions, responsibilities, and powers. Conceptualizing the organization is not a difficult problem. Human resources departments are in place and well suited to organize a voting scheme. One can expect objections based on the alleged difficulty of the task, but such opposition would not be credible given that corporations are by nature organized hierarchically.

Second, although a public company may have sprawling international operations, voting should be limited to U.S.-based employees. The practical reason is that wage standards across the globe vary radically.[180] In terms of monitoring capabilities and inside information, U.S.-based employees of U.S. firms would probably be better, generally, due to knowledge gained from closer physical, informational, and relational proximities.

Finally, the most difficult implementation issue is how to allocate votes. The board should have discretion to exercise business judgment, subject to regulatory guidelines against gaming, to allocate votes within the corporate hierarchy in a way that achieves informed voting. The allocation can be in the form of a report and proposal to the SEC, discussing the corporation's organization, categorization of employees, vote allocation assignments per category, and the rationale for particular assignments. Even if allocating votes is difficult, boards and executives are paid to exercise judgment on difficult matters.

180. For example, in 2011 the average Chinese worker earned approximately 42,000 yuan per year, which is approximately $6900 (at a conversion rate of 1 yuan to $0.16). *Wages and Employment*, CHINA LABOUR BULLETIN (Aug. 4, 2015), http://www.clb.org.hk/en/content/wages-china [perma.cc/7459-YQV8] (noting that the average worker made 3,500 yuan monthly in 2011). This figure is significantly lower than the average U.S. worker pay. *See supra* note 39 and accompanying table.

Unlike shareholder voting—which occurs through an existing proxy process—a company must create a new voting process to achieve employee say-on-pay. This raises the question of cost. Under the standard theory, agency cost is defined as the sum of the contracting cost between principal and agent, monitoring cost by the principal, the bonding cost by the agent, and the residual loss.[181] This theory suggests that some rent extraction by CEOs may be efficient (economically tolerable) if the monitoring costs of such behavior are greater than the rent extracted.[182]

The cost of establishing voting will not be high relative to the issue at stake. The organizational structure already exists, and the most difficult aspect of constructing a voting scheme is the exercise of judgment—not an outlay of any significant cash or hard resource costs. Voting would not be a mandatory condition of employment, but, similar to political voting, a voluntary act of participation.

Voting can be done electronically. Corporations can easily create a voting portal in which employees can login through a company-issued identification, such as a password or social security number, and vote on the package.[183] Business enterprises achieve amazing feats of organization, data collection, analysis, and use of information technology.[184] An objection that voting would be technologically infeasible or too costly as a direct expenditure would defy credibility based on everyday observations of the routine use of information technology by many parts of society including business corporations.

In conclusion, the technical aspects and direct costs of implementation are minimal. The real issue is whether employee say-on-pay would produce better corporate governance as to executive compensation, and whether these benefits are outweighed by potential objections. These issues are discussed in the next two sections.

181. Jensen & Meckling, *supra* note 19, at 308; *see* MICHAEL C. JENSEN, A THEORY OF THE FIRM: GOVERNANCE, RESIDUAL CLAIMS, AND ORGANIZATIONAL FORMS 86–87 (2000).

182. *See* Frydman & Jenter, *supra* note 158.

183. *See* Adams, *supra* note 18, at 432 (stating that full-circle evaluations can be administered through the internet "without much added cost").

184. *See, e.g.*, Charles Duhigg, *What Does Your Credit-Card Company Know About You?*, N.Y. TIMES, May 12, 2009, at MM40 (discussing how credit card companies can predict individual consumer behavior through data collection and analysis).

III. BENEFITS OF INTRAFIRM EMPLOYEE MONITORING

A. Advantages of Private Information

Employees, including management, collectively possess the corporation's entire information content.[185] The advantage of employees as monitors compared to shareholders becomes apparent when we consider the question of information through the lens of market efficiency. Economists have categorized levels of market efficiency: strong, semi-strong, and weak.[186] The weak form states that past information such as stock prices has been incorporated into the current stock price, and it is certainly correct.[187] The semi-strong form states that stock prices adjust immediately to all publicly available information. There is a question of whether the market is always semi-strong efficient,[188] but one can say without controversy that the market often rapidly incorporates publicly disclosed information such as press releases, disclosures, and annual reports.[189] The strong form states that the stock price incorporates all public and private information, and this version of market efficiency is certainly incorrect.[190] Public

185. *See* Dau-Schmidt, *supra* note 25, at 800 (arguing that management and labor together have important informational advantage over shareholders because they are "insiders" and possess private information).

186. *See* Eugene F. Fama, *Efficient Capital Markets: A Review of Theory and Empirical Work*, 25 J. FIN. 383, 383 (1970) (proposing that there are three types of market efficiency, which are strong, semi-strong, and weak forms of efficiency); *see also* Ronald J. Gilson & Reinier H. Kraakman, *The Mechanisms of Market Efficiency,* 70 VA. L. REV. 549, 565–92 (1984) (discussing the efficient capital market hypothesis and the three forms of market efficiency).

187. FRANK J. FABOZZI & FRANCO MODIGLIANI, CAPITAL MARKETS: INSTITUTIONS AND INSTRUMENTS 308–11 (2d ed. 1996).

188. *See id.* at 309 ("Evidence on semi-strong pricing efficiency is mixed."); *see also* WILLIAM W. BRATTON, CORPORATE FINANCE: CASES AND MATERIALS 36 (7th ed. 2012) ("The number of EMH supporters in the financial economic community has dwindled."); Robert J. Shiller, *We'll Share the Honors, and Agree to Disagree*, N.Y. TIMES, Oct. 27, 2013, at BU6 ("I have argued that the theory makes little sense, except in fairly trivial ways. Of course, prices reflect available information. But they are far from perfect."). The presumption of market efficiency is the basis for the fraud-on-the-market theory of Rule 10b-5 securities fraud actions. *See* Basic, Inc. v. Levinson, 485 U.S. 224, 241–47 (1988). There are nuances to market efficiency, such as the degree and time responsiveness in which public information is absorbed, that are important in securities actions. *See* Donald C. Langevoort, *Basic at Twenty: Rethinking Fraud on the Market*, 2009 WIS. L. REV. 151, 167 (2009); Baruch Lev & Meiring de Villiers, *Stock Price Crashes and 10b–5 Damages: A Legal, Economic, and Policy Analysis*, 47 STAN. L. REV 7, 20 (1994); Lynn A. Stout, *The Mechanisms of Market Inefficiency: An Introduction to the New Finance,* 28 J. CORP. L. 635, 656 (2003). These nuances are not relevant for the discussion here.

189. *See* Halliburton Co. v. Erica P. John Fund, Inc., 134 S. Ct. 2398, 2410 (2014) ("Even the foremost critics of the efficient-capital-markets hypothesis acknowledge that public information generally affects stock prices.").

190. "No one these days accepts the strongest version of the efficient capital market hypothesis, under which non-public information automatically affects prices. That version is

shareholders do not have private information. With this broad outline of the efficient market hypothesis in mind, it is clear that even if shareholder voting is informed (a questionable assumption in light of rational apathy[191]), it only incorporates publicly available information, which ultimately reduces to a matter of the stock price for shareholders.[192]

On the other hand, employees have not only all of the public information available to shareholders, but they also collectively possess all private information. As used here, "private information" is not a specific reference to highly confidential, particularized information that is typically subject to insider trading laws.[193] Rather, it refers to all information relevant to the performance of the firm and its executives that exists within the firm, but is not readily accessible to the public. It is institutionally-held information. Such information may include knowledge of specific matters of business operations and strategy, more generalized information on the sense of organizational "well-being" and trajectory, company morale and confidence, and the long-term performance history of the company. These kinds of information are indicators of past and present firm performance and expectation of future performance. Until specific information is publicly disclosed, they are private information held within the firm by the collective employees.

If one believes that there is a one to one correlation between information that is readily publicly available, such as public disclosures and press releases, and the private information held by employees (that is, the strong form of market efficiency), there would be no rationale for employee monitoring on efficiency grounds. Shareholders can and should perform the same function. However, no company is perfectly transparent, and private information always exists.

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empirically false: the public announcement of news (good and bad) has big effects on stock prices, which could not happen if prices already incorporated the effect of non-public information." West v. Prudential Sec., Inc., 282 F.3d 935, 938 (7th Cir. 2002); *see, e.g.*, Leslie A. Jeng, Andrew Metrick & Richard Zeckhauser, *Estimating the Returns to Insider Trading: A Performance-Evaluation Perspective*, 85 REV. ECON. & STATISTICS 453, 453 (2003) (finding abnormal returns of more than six percent per year from insider purchase); Arthur J. Keown & John M. Pinkerton, *Merger Announcements and Insider Trading Activity: An Empirical Investigation*, 36 J. FIN. 855, 855 (1981) (showing rapid rise of stock price to reflect merger announcements and acquisition premiums).

191. *See supra* Section I.D.

192. *See* Kang, *supra* note 18, at 1301 ("However, even rationally ignorant shareholders can monitor their company's performance at low cost with reference to simple proxies like share price.").

193. *See* United States v. O'Hagan, 521 U.S. 642, 660 (1997) (involving misappropriation of confidential information under the securities laws).

Shareholder and employee monitoring can work at different levels of market efficiency.[194] Shareholders are most likely to vote "no" when share prices are declining, and as a result, can be said to reflect the publicly available information. If employees have a say, they would be most likely to vote "no" when the information they hold on the executive's role in the corporation's past performance and expectation for the future conflicts with the pay package. This would incorporate private information into the voting mechanism. One view of the purpose of corporate voting is "a means of error correction for decisions."[195] The shareholder and employee votes, respectively, would correct potentially erroneous decisions of boards on executive compensation that could have significant impact on corporate earnings, executive incentives, and broader social effects. Shareholders would correct errors on the basis of the relationship between stock price and compensation, and employees would correct errors on the basis of private information and compensation. The idea of market efficiency suggests that there are limits to shareholder knowledge and information, and that corporate insiders have better information than the public market. Employee voting therefore augments the information mix given to the board.

B. Reverse Monitoring

Employees are said to have many roles, including citizens at work, stakeholders, human capital, and investors.[196] Employees can also be monitors. In this case, the function is reverse monitoring: employees monitor their coworkers, including their supervisors, and are not just the targets of monitoring themselves by the company writ large.[197] We typically think of evaluation and monitoring in the corporate hierarchy as a sequence of top-down processes emanating from the board to the senior officers, and progressively down toward the base of the pyramid. But in corporate management practice, monitoring can be multidirectional.

The theory of reverse monitoring has been applied in different contexts. It has been suggested that, contrary to conventional wisdom

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194. *See* Dau-Schmidt, *supra* note 25, at 800–01 (suggesting that shareholders can monitor at the level of market efficiency while employees can monitor the firm as "insiders").

195. Thompson & Edelman, *supra* note 168, at 130; *see* Kang, *supra* note 18, at 1326 ("Thompson and Edelman's real point, I think, is that shareholders are well positioned to develop and vote on negative preferences about corporate management in ways that they are not similarly positioned with respect to affirmative preferences. I agree.").

196. Arthurs & Mummé, *supra* note 29, at 352–67.

197. Sharon Hannes, *Reverse Monitoring: On the Hidden Role of Employee Stock-Based Compensation*, 105 MICH. L. REV. 1421, 1423–24, 1446 (2007).

that stock options impart ownership incentives on employees, employee stock options promote a reverse monitoring function, wherein employees are incentivized to monitor peer misconduct or shirking so as to avoid a decline in the value of their options.[198] Whistleblower protection and *qui tam* actions are based on the idea that employees can monitor the corporation and their peers for wrongdoing on behalf of the corporation or the public.[199] Reverse monitoring is based on the belief that employees should have both the incentive and the means to monitor organizational governance.[200]

Reverse monitoring is also commonly used in management practice. Many major public corporations routinely use "full-circle" or "360 evaluations" where subordinates evaluate the performance of their supervisors.[201] Such evaluations steadily gained acceptance in the 1980s and 1990s both as a decision-making tool and a method for evaluating management.[202] Full-circle evaluations provide crucial information on the performance of senior managers from those they supervise. This Article extends the concept so that all subordinates participate in a firm-wide evaluation of senior executive officers. It is not clear why the CEO and the most senior executive officers, also being employees, should be inherently exempt from such evaluations and management practices that are applied to most other employees. Voting would simply formalize opinions already held.

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198. *Id.* at 1423–25. The idea is that individual employees can do more harm to the corporation than they can increase value. Stock options incentivize reverse monitoring by employees whose options may be subject to destruction of value by other employees. *Id.* at 1423–24.

199. *See, e.g.*, Dodd-Frank Wall Street Reform and Consumer Protection Act, Pub. L. No. 111-203, § 922, 124 Stat. 1376, 1841–49 (2010) (codified at 15 U.S.C. § 78u-6 (2012)) (providing whistleblower protection); Sarbanes-Oxley Act § 806, 18 U.S.C. § 1514A (2012) (same); False Claims Act, 31 U.S.C. §§ 3729–3733 (2012) (providing for *qui tam* action for fraud against the U.S. government).

200. *See* Hannes, *supra* note 197, at 1424 ("It is hard to imagine anyone in a better position to fulfill this [monitoring] mission [than employees], and because their explicit duties do not include this task, it is wise to give them an incentive to do so . . . ."); *see generally* Orly Lobel, *Citizenship, Organizational Citizenship, and the Laws of Overlapping Obligations*, 97 CAL. L. REV. 433 (2009) (discussing the role of employees in ensuring the legality and compliance obligations of organizations).

201. *See* Adams, *supra* note 18, at 429–35 (discussing the development, use, and benefits of full-circle evaluations). Companies like Walt Disney, General Motors, American Airlines, Intel, DuPont, IBM, and RCA have used full-circle evaluations. *Id.* at 431, 433. According to one survey, ninety percent of Fortune 1000 companies surveyed had implemented some form of full-circle or multisource evaluation system. *Id.* at 433 (citing Mark R. Edwards & Ann J. Ewen, *How to Manage Performance and Pay with 360-Degree Feedback*, COMPENSATION & BENEFITS REV., May/June 1996, at 41)*; see also* H. John Bernardin & Richard W. Beatty, *Can Subordinate Appraisals Enhance Managerial Productivity?*, 28 SLOAN MANAGEMENT REV. 63, 68–72 (1987) (arguing for giving employees "voice" in the performance evaluation of their supervisors).

202. Adams, *supra* note 18, at 429.

The idea that employees can serve as monitors of peers and superiors is based on the fact that they collectively possess all private information.[203] Not even the CEO would possess this quantity of information, and the board certainly would not. An employee vote would divulge this information content. Since this inside information is valuable, the rationale for reverse monitoring is compelling.

Employee monitoring is costless and requires only awareness.[204] One may question the quality of the information that is revealed. In large corporations, direct observations cannot be made in some circumstances. Most CEOs would be incompetent to evaluate most employees in the company due to the fact that they would not have personal observations arising from direct professional dealings. As a factual corollary, most employees are not in day-to-day contact with the CEO and other senior executives. Does this mean that employees would be equally incompetent to judge the CEO's performance? The apparent symmetry of argument does not hold. Employees are competent to judge executive performance.

Interpersonal dealings with the CEO are not the only ways that employees can serve a monitoring and evaluation function. There is direct assessment when employees execute the decisions of the CEO and observe the influence of such decisions on the corporate performance and prospects. Information in a corporation is not like water, always flowing downwards; it is like air, ubiquitous in the complex networks of professional relationships and institutional processes. All employees have organizational awareness resulting from being a part of the firm's complex information network. Information is transmitted and received multi-directionally in a complex organization.[205] The general sense of the collective employees is often accurate.[206] One need not be a historian to understand that there have been countless past instances in which leaders of organizations—be they military, corporate, civic, or governmental—have lost the confidence of their subordinates or constituents for reasons that proved to be well founded. Such failed leaders frequently lose their jobs or

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203. "[I]nformation is always more complete and reliable within the firm than outside it." PHAN, *supra* note 22, at 15.

204. Hannes, *supra* note 197, at 1424.

205. *See* CHESTER I. BARNARD, THE FUNCTIONS OF THE EXECUTIVE 104–11 (1938) (describing the networks of relationships and communication channels in a complex organization and showing the mathematical permutations of relationships within a firm).

206. *Cf.* Robert J. Rhee, *Terrorism Risk in a Post-9/11 Economy: The Convergence of Capital Markets, Insurance, and Government Action*, 37 ARIZ. ST. L.J. 435, 524 n.437 (2005) (discussing the ability of the futures markets to predict accurately on a probabilistic basis political and sporting outcomes); *see generally* JAMES SUROWIECKI, THE WISDOM OF CROWDS (2005) (discussing how large groups of people accurately observe, assess, or solve better than a few individuals).

suffer other consequences as a result of the collective disappointment and disapproval of their constituents. In the context of corporate governance, the problem to solve is how to deliver the information that is held by subordinates to the decision-maker (the board) consistent with the traditional principle of the primacy of board authority.

It is doubtful that the board, as a collective group working part-time and relying on information provided by senior management, would know more about the performance of the CEO than the collective employees, especially the cadre of middle and senior managers and the senior executive team. From an informational standpoint, the problem for the board becomes greater as the corporation increases in size and complexity, and as the board increasingly relies on information provided by the CEO and the outside advisers hired by the senior executives.[207] Since employees possess highly relevant information, full-circle evaluations can serve a reverse monitoring role in evaluating the compensation packages of senior executives.[208]

Lastly, there is a special form of monitoring and assessment that may have particular usefulness in executive compensation. In some instances, executive compensation may be patently excessive or obscene—either based on absolute amount[209] or in relation to firm performance[210] or the average worker pay.[211] These cases may incite a collective visceral reaction that serves a useful purpose in these extreme cases. Although even gross excessiveness of pay may be unable to overcome shareholder inertia (at least sufficiently to obtain a majority negative vote), monitoring by employees may be more effective in these special situations. Such monitoring may signal an error in the business judgment of the board, which has virtually complete legal authority absent breach of loyalty, and thus places soft constraints on potential cases of gross error of judgment.

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207. *See* MACEY, *supra* note 49, at 83–84 (explaining the reliance of boards on management to provide information and the resulting power dynamic leading to "board capture").

208. *Cf.* Adams, *supra* note 18, at 435, 437 (arguing that institutional investors use full-circle evaluations from middle managers, among others, to evaluate the compensation packages of senior executives).

209. *See, e.g., In re* Walt Disney Co. Derivative Litig., 906 A.2d 27, 35 (Del. 2006) (noting that a corporate executive was paid approximately $130 million for fourteen months of work).

210. *See, e.g.*, Annie Lowry, *Pay Still High at Bailed-Out Companies, Report Says*, N.Y. TIMES (Jan. 28, 2013), http://www.nytimes.com/2013/01/29/business/generous-executive-pay-at-bailed-out-companies-treasury-watchdog-says.html?r=0 [perma.cc/2R96-VUP2] (reporting that executive compensation was high even for financial firms bailed out during the financial crisis).

211. *See, e.g.*, Elliot Blair Smith & Phil Kuntz, *CEO Pay 1,795-to-1 Multiple of Wages Skirts U.S. Law*, BLOOMBERG (Apr. 30, 2013, 12:01 AM), http://www.bloomberg.com/news/2013-04-30/ceo-pay-1-795-to-1-multiple-of-workers-skirts-law-as-sec-delays.html [perma.cc/E9PX-67FE] (reporting that the CEO of J.C. Penney was paid $53.3 million while the average employee was paid $29,688).

C. Information Asymmetry in Governance

A well-known paradox of corporate governance is that the board is the ultimate managerial authority charged with "managing" senior executives,[212] but the latter possesses greater information.[213] The typical board meets four to six times per year for an average of four hours per meeting.[214] Information is the source of power and influence.[215] Management power inures from the distinct information asymmetry between board and management.[216] If the board had the same or superior information, it could always second-guess or countermand management opinions, recommendations, and decisions. In the logical extreme, there would be no need for operational managers.

In reality, much of the corporation's information is held below the board level, synthesized, and then sent upwards in the corporate hierarchy in the reporting process. Senior managers are the conduit through which information flows to the board. In most corporate hierarchies, the board does not have much contact with lower level employees in the course of managing the business and affairs of the corporation. This is not a failing of boards, but instead a limitation of corporate organization. Consider a corporation that has 50,000 employees, 1,000 of whom are non-executive managers. Not only do many (or most) board members have primary careers elsewhere, but their numbers are also woefully insufficient for operational management. Rather, operational management is the job of the senior officers. The liability scheme in corporation law recognizes this reality that the board, while technically the ultimate managers, cannot directly engage the largest segment of management.[217]

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212. DEL. CODE. ANN. tit. 8, § 141(a) (2015); MODEL BUS. CORP. ACT § 8.01(b) (1969) (AM. BAR ASS'N, amended 2010).

213. MACEY, *supra* note 49, at 83 ("Generally speaking, management's control of the flow of information to the board of directors creates a dynamic in which management is able to capture its board of directors by controlling the nature of the information available to directors when making decisions."); PHAN, *supra* note 22, at 145; *see* ROBERT A.G. MONKS & NELL MINOW, CORPORATE GOVERNANCE 295 (5th ed. 2011) ("Directors can never know as much about the operation of the company as management, so they are dependent on the CEO for being supplied with accurate, timely, and material information.").

214. PHAN, *supra* note 22, at 37.

215. *See* Dau-Schmidt, *supra* note 25, at 800 ("Management has important informational advantages over shareholders because members of management are 'insiders' with important information on the day-to-day running of the firm.").

216. MACEY, *supra* note 49, at 83–84, 96; PHAN, *supra* note 22, at 146.

217. A failure of the duty to monitor is "possibly the most difficult theory in corporation law upon which a plaintiff might hope to win a judgment." *In re* Caremark Int'l Inc. Derivative Litig., 698 A.2d 959, 967 (Del. Ch. 1996). In Delaware, the standard is "a sustained or systematic failure

Just because boards cannot in reality actively engage in operational management does not mean that the knowledge gained from such management, if it could hypothetically be aggregated, would be irrelevant. Indeed, if a board could acquire such knowledge, the information would be highly relevant toward the evaluation of senior officers. Consider the agency problem of monitoring corporate executives through a Coasean lens. In the context of legal entitlements, if transaction costs were zero, parties would rearrange their rights in a way that maximizes efficiency irrespective of the initial assignment of the rights.[218] But once transaction costs are considered, the rearrangement of rights only occurs if the increase in production exceeds the cost of bringing about this reordering.[219] The law should initially assign rights in a way that reflects the hypothetical bargain of the parties;[220] organizational law can be analyzed from this perspective.[221]

One can analyze the agency cost problem of monitoring corporate executives through a Coasean lens. If monitoring costs were zero, the board would vigorously monitor and manage executives. This monitoring would entail acquiring and analyzing information held in the firm. The board would solicit information from employees, in the very same way that senior executives solicit information from subordinates. Since the real world has monitoring costs and limited resources, such operational management is infeasible. However, if information conveyance can be cost effective, the board would benefit. One such device is employee reverse monitoring. The point is fairly obvious: Would employees have something to add in a hypothetical board deliberation on the CEO's performance if the interchange and monitoring costs were low? Although a board cannot directly acquire

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of the board to exercise oversight—such as an utter failure to attempt to assure a reasonable information and reporting system." *Id.* at 971.

218. R.H. Coase, *The Problem of Social Cost*, 3 J.L. & ECON. 1, 2–7, 15 (1960).

219. *Id.* at 15–16. Unless the initial arrangement of rights established by the legal system is efficient, "the costs of reaching the same result by altering and combining rights through the market may be so great that this optimal arrangement of rights, and the greater value of production which it would bring, may never be achieved." *Id.* at 16.

220. Robert J. Rhee, *Toward Procedural Optionality: Private Ordering of Public Adjudication*, 84 N.Y.U. L. REV. 514, 566 (2009). Courts have used the analytic heuristic of an ex ante hypothetical transaction to determine the most efficient rule of law. *See, e.g.*, Stockberger v. United States, 332 F.3d 479, 483 (7th Cir. 2003) (Posner, J.) (noting that "[h]ypothetical-contract analysis is a powerful tool for understanding tort law and determining its scope"); Bamford v. Turnley (1862) 122 Eng. Rep. 27, 33, rev'g (1860) 122 Eng. Rep. 25 (analyzing a nuisance case from a hypothetical decision of an individual owner of the properties in question).

221. *See* LARRY E. RIBSTEIN, THE RISE OF THE UNCORPORATION 37 (2010) ("When filling gaps in the corporate contracts, courts cannot look to the actual intent of thousands of parties so they make up a hypothetical 'intent' based on what the courts view as reasonable.").

the knowledge gained from either direct operational management or communication with employees, the mechanism of employee voting can be an efficient substitute for transmitting relevant information to the board.

Employee voting is a modest device that provides a more diverse mix of information to the board. An important aspect of say-on-pay is the quantum of information: a simple percentage signifying approval or disapproval. Shareholder say-on-pay provides direct, relevant input on the opinion of shareholders. This opinion is based on market and public information. Employee say-on-pay remedies the problem of information asymmetry between board and management by providing direct, relevant input on the opinion of employees.

In the ideal world of zero monitoring costs, a perfectly informed board would gather information from both senior management *and* employees, who collectively hold the entire information content of the firm,[222] and assign appropriate levels of materiality in the exercise of business judgment. Employee voting provides relevant information that is relatively costless. This mechanism helps to offset the informational power of management over the board, which can promote board capture and work against good corporate governance.

D. Duration of Information and Outlook

In addition to the advantage of having private information, employees have a longer-term experience and outlook with respect to the corporation. The average hold period of shareholders is short, and getting shorter.[223] The average shareholder may not even hold the stock of a company for a full year.[224] The short-term time horizon of

222. In some companies, the board has complete access to employees according to their corporate governance guidelines. For example, the board of Intel has complete access while the board of General Motors is restricted in its access by management. PHAN, *supra* note 22, at 172–73.

223. *See* Robert C. Pozen, *Curbing Short-Termism in Corporate America: Focus on Executive Compensation*, GOVERNANCE STUD. AT BROOKINGS, May 2014, at 3 n.5 (stating that the average holding period for US stocks has fallen from seven years in 1960 to two years in 1992 to less than eight months in 2007); Roe, *supra* note 140 (suggesting that large mutual funds hold stocks for approximately 1.5 years); Andrew Haldane, Executive Director, Financial Stability, Bank of England, Patience and Finance, Speech at the Oxford China Business Forum 17 chart 9 (Sept. 9, 2010), http://www.bis.org/review/r100909e.pdf [perma.cc/6338-QZV7] (showing the average hold period of stocks on the New York Stock Exchange in 2005 to be approximately one year).

224. *See* Pozen, *supra* note 223 (stating that the average holding period for US stocks was less than eight months in 2007); Jesse Eisinger, *Challenging the Long-Held Belief in 'Shareholder Value'*, N.Y. TIMES (June 27, 2012, 12:00 PM), http://dealbook.nytimes.com/2012/06/27/challenging-the-long-held-belief-in-shareholder-value/?_r=0 [perma.cc/3C2W-UWM6] ("The average holding period of a stock was eight years in 1960; today, it's four months.").

shareholders, and managers responding to shareholder short-termism, has become a source of concern and been blamed for many ills in corporate governance and the financial markets.[225]

Short-termism affects shareholder monitoring. Firstly, in addition to a minority shareholder's lack of incentive, a short-term shareholder would also be rational in being apathetic toward monitoring a firm that she expects to exit shortly. Secondly, a short-term investor invests with information necessary to make the investment within the expected hold period. There may not be long-term "look back" into the past and "look forward" into the future. For the purposes of assessments of firm performance and outlook, and their connection to executive performance, the quality of the information may be suspect. Each individual shareholder has knowledge of the firm, but this knowledge is limited by public disclosure. Furthermore, many shareholders, if not most, are not active consumers of public information, but instead rely on an efficient market to do the hard work of incorporating information into the stock price.[226]

On the other hand, employees have specific information and a longer term investment of careers in the corporation. It is true that many employees are transient and that most corporate employees change jobs during the course of a career. However, the turnover rate in the labor market is far lower than the turnover rate of stockholding.[227] For corporate managers, both midlevel and senior, the human capital investment in a company is even longer than rank-and-file employees, who are more transient.

Employees have longer term duration and outlook, and this perspective is significant. They monitor and assess from this perspective. Like shareholders, they have the same access to public information and stock price information; unlike shareholders, they also possess specific information on the firm and longer duration of

225. *See* Dau-Schmidt, *supra* note 25, at 771 (suggesting that management has succumbed to shareholders' short-term interests and that employees with longer term interest in the firm have no means to provide input on corporate governance); *see generally* PAVLOS E. MASOUROS, CORPORATE LAW AND ECONOMIC STAGNATION: HOW SHAREHOLDER VALUE AND SHORT-TERMISM CONTRIBUTE TO THE DECLINE OF THE WESTERN ECONOMIES (2013); Lynne L. Dallas, *Short-Termism, the Financial Crisis, and Corporate Governance*, 37 J. CORP. L. 265 (2012); Mark J. Roe, *Corporate Short-Termism—In the Boardroom and in the Courtroom*, 68 BUS. LAW. 977 (2013).

226. This is the basic principle underlying the fraud-on-the-market theory of securities fraud. *See* Halliburton Co. v. Erica P. John Fund, Inc., 134 S. Ct. 2398, 2408 (2014) (explaining that the typical investor transacts at the price set by the market "in reliance on the integrity of that price" rather than scrutinizing all public information); Basic, Inc. v. Levinson, 485 U.S. 224, 241–42 (1988) (explaining the basis of the fraud-on-the-market theory).

227. *See* News Release, Bureau of Labor Statistics, Job Openings and Labor Turnover—May 2015 (July 7, 2015), http://www.bls.gov/news.release/archives/jolts_07072015.pdf [perma.cc/ FA73-S425] (stating that the quits rate was 1.9% and the total separations rate was 3.3%).

information. Employees have longer term investments of human capital and careers, and accordingly they think in longer duration terms.

E. Fiduciary Ideals

Employee monitoring promotes fiduciary ideals and board independence. The "board capture" criticism asserts that corporate governance has broken down in the realm of executive compensation.[228] The board is a fiduciary of the corporation. While the legal rules of corporate governance make it exceedingly difficult to impose liability for the board's breach of fiduciary duty, fiduciary ideals set forth normative virtues for director motives and behavior.[229] However, there are many instances in which fiduciary duties are not in fact kept. Is there any doubt by the litigator or the corporate lawyer that perfect processes can and do mask improper intentions that would never see the light of a courtroom?[230] Corporate governance and adjudications in corporate law are not so special that they rise above the limitations of the adjudicatory process and the nature of truth.[231]

In executive compensation, the fiduciary ideal is axiomatic and incontestable: the board should award compensation free of structural bias in favor and independent of management, informed with all public and private information available, based on the idea of pay-for-performance, and without heed to any sense of executive entitlement or rent extraction. Employees can advance this fiduciary ideal. The information that they communicate enhances informed decision-making, which is the hallmark of the fiduciary duty of care.[232]

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228. *See supra* Section I.A.

229. Commentators have suggested that corporate law incorporates standards of conduct as opposed to legal rules of liability. *See* Melvin Aron Eisenberg, *The Divergence of Standards of Conduct and Standards of Review in Corporate Law*, 62 FORDHAM L. REV. 437, 439–58 (1993) (examining the divergence between standards of conduct and standards of review); Edward B. Rock, *Saints and Sinners: How Does Delaware Corporate Law Work?*, 44 UCLA L. REV. 1009, 1012–17 (1997) (discussing the development of standards of conduct within corporations).

230. *See* MACEY, *supra* note 49, at 30–31, 74–75 (criticizing the process-oriented nature of corporate governance following *Smith v. Van Gorkom*, 488 A.2d 858, 872–73 (Del. 1985)).

231. For example, the old chestnut, *Kamin v. American Express Co.*, 383 N.Y.S.2d 807 (1976), can be understood from the divide between the probable and the provable:

> It can be explained by improper but unprovable motives such as a vain attempt to support short-term stock prices for the purpose of executive compensation, or obfuscating the nature of a failed investment which would have been made clearer with the recognition of a loss. Thus, *Kamin* can be seen as an unprovable duty of loyalty case that had to be brought as a duty of care case.;

Rhee, *supra* note 77, at 1149 n.56.

232. *See* Cede & Co. v. Technicolor, Inc., 634 A.2d 345, 367 (Del. 1993) ("The duty of the directors of a company to act on an informed basis . . . forms the duty of care . . . ."); Smith v. Van

In corporate governance, the board and the management share a necessary symbiotic relationship. A board depends heavily on senior management for information that it uses to make decisions. Control of information is an essential source of power and influence in an organization, and it is why senior executives have control and influence even as the board has the power to fire them. However, a negative aspect of the codependency of board and management is structural bias.[233] CEOs have significant influence on board compensation and nominations. Insider board members, such as senior executives, are subject to the CEO's authority in their roles as officers.[234] The board is a social institution populated by an elite group of individuals who routinely interact with each other in their business, social, and political worlds.[235] Although a genial and collegial working relationship between the board and the management is a good thing, it can also lead to structural bias.[236]

A number of devices tend to offset structural bias and power balance and empower greater board independence. Board members are subject to fiduciary duty.[237] They routinely retain outside advisers on various matters such as lawyers and financial advisers. There are legal requirements on the appointment of independent directors,[238] the

Gorkom, 488 A.2d 858, 872–73 (Del. 1985) (describing a director's duty to exercise informed business judgment).

233. *See* MACEY, *supra* note 49, at 57–65 (suggesting that boards are susceptible to "board capture" by management).

234. *See, e.g.,* ATR-Kim Eng Fin. Corp. v. Araneta, No. CIV.A. 489-N, 2006 WL 3783520, at *1 (Del. Ch. Dec. 21, 2006) (stating that certain officers and directors "acted as—no other word captures it so accurately—stooges" for a controlling shareholder); Bayer v. Beran, 49 N.Y.S.2d 2, 9 (Sup. Ct. 1944) (involving business transactions by the corporation with "a close relative of the chief executive officer of a corporation, and one of its dominant directors").

235. *See generally* Rakesh Khurana & Katharina Pick, *The Social Nature of Boards*, 70 BROOK. L. REV. 1259 (2005) (discussing the social environment of a board and the resulting behavior of board members).

236. *See* BEBCHUK & FRIED, *supra* note 6, at 61–79 (discussing structural bias in compensation); *see also* Kenneth B. Davis, Jr., *Structural Bias, Special Litigation Committees, and the Vagaries of Director Independence*, 90 IOWA L. REV. 1305, 1307–09 (2005) (discussing "structural bias"). *See generally* Claire A. Hill & Brett H. McDonnell, *Disney, Good Faith, and Structural Bias*, 32 J. CORP. L. 833 (2007) (discussing structural bias in compensation and the *Disney* compensation litigation).

237. *See, e.g.*, Cede & Co. v. Technicolor, Inc., 634 A. 2d 345, 360–61 (Del. 1993); Smith v. Van Gorkom, 488 A.2d 858, 872 (Del. 1985).

238. *See, e.g.*, N.Y.S.E LISTED COMPANY MANUAL, *supra* note 87, at § 303A.01 ("Listed companies must have a majority of independent directors.").

composition of important committees of the board,[239] and board deliberation procedures.[240]

Employee monitoring can also counteract structural bias. The board would receive information independent of management control. A board would find it uncomfortable to ignore a negative vote of either shareholders or employees. The sense of public accountability would be great. Ignoring the concerns of employees, particularly concerns arising from the managerial ranks, would be detrimental to business operations. The board would be viewed as insensitive to employees and managers in general if they did ignore such responses. If excessive executive compensation is a possibility due to structural bias, employee voting could offset some of this.

Employee voting can further enhance board independence because it can provide a factual basis and justification for the board's compensation decision even when structural bias may tend to work the opposite effect. Consider different scenarios: a board may want to award high compensation in a facially difficult situation for proper reasons; or, it may not want to award high compensation but the social, political, and bargaining situation is complex. A normative basis for engaging in compensation negotiation would be helpful.[241]

Consider a facially difficult situation. The board of a distressed company proposes to award a CEO with high compensation. Depending on the circumstance, a board could rightly award high compensation in such cases. Management talent would be needed to right the ship, and such talent would have opportunity costs. Good executives may have other better opportunities and may be wary of entering into a bad situation unless the incentives compensate for those foregone opportunities. These situations can be politically difficult internally and externally. But suppose employees, properly recognizing the situation, vote positively. Who can complain in such a case?

Consider the case where a board seeks to rein in compensation for rational reasons, but has complex considerations in scaling back executive pay.[242] Working against the board's inclination on executive

239. *See, e.g.*, *id.* at § 303A.04(a) ("Listed companies must have a nominating/corporate governance committee composed entirely of independent directors."); *id.* at § 303A.05(a) ("Listed companies must have a compensation committee composed entirely of independent directors.").

240. *See, e.g.*, *id.* at § 303A.03 ("To empower non-management directors to serve as a more effective check on management, the non-management directors of each listed company must meet at regularly scheduled executive sessions without management.").

241. *See* G. RICHARD SHELL, BARGAINING FOR ADVANTAGE: NEGOTIATION STRATEGIES FOR REASONABLE PEOPLE 89–114 (2d ed. 2006) (suggesting that various kinds of leverage exist to bargain successfully).

242. *See* PHAN, *supra* note 22, at 47–62 (presenting a case study of a company and board that were highly influenced by the CEO).

pay may be the social bonds between board members and the CEO, a prior history of high wages, CEO influence on particular board members such as insider members, and a reticence to disturb collegiality. Many of these factors create the structural bias in favor of CEO deference. In this situation, a negative employee vote can give the board leverage in an arms-length negotiation, and normative justification for the decision to reduce compensation.

F. Public Monitoring and Political Legitimization

At this moment in time and compensation levels, the public has come to view executive compensation as rent extraction gained through the power of position, unconstrained by personal qualms.[243] Given the extent of the problem, one cannot predict with complete confidence where future reform, if any, will go. Reform of compensation can be done through tax law.[244] It can be done through flat restrictions or caps on compensation.[245] In the extreme case, the government can have a direct role in determining how much an executive can pocket in compensation through special taxes or wage control.[246]

This Article argues that employees can serve as public monitors and gatekeepers.[247] Public approval is needed to legitimize, socially and politically, high executive compensation, though at this time public disapproval and shaming have not deterred the conspicuous awarding of compensation.[248] Without this legitimacy, boards will continue to feel a pervasive public pressure even as they continue to approve high compensation packages.

Even as CEOs are enjoying high compensation, there is long-term uncertainty. Social cohesion in a corporation was stronger in the past than it is now.[249] Current compensation levels strike discord in broad constituencies. A compensation package should be broadly

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243. *See* STIGLITZ, *supra* note 12, at 53 (noting that CEOs have amassed riches through "an enhanced ability to take more from the corporation that they are supposed to be serving, and weaker qualms about, and enhanced public toleration of, doing so").

244. *See* Ethan Yale & Gregg D. Polsky, *Reforming the Taxation of Deferred Compensation,* 85 N.C. L. REV. 571, 592–634 (2007) (proposing a tax-based solution).

245. *See generally* Ingolf Dittmann, Ernst Maug & Dan Zhang, *Restricting CEO Pay*, 17 J. CORP. FIN. 1200 (2011) (examining such a measure).

246. *See* Landon Thomas, Jr., *Britain to Levy a One-Time Tax on Banker Bonuses*, N.Y. TIMES (Dec. 9, 2009), http://www.nytimes.com/2009/12/10/business/global/10pound.html [perma.cc/QF9V-M6KN].

247. *See generally* JOHN C. COFFEE, GATEKEEPERS: THE ROLE OF THE PROFESSIONS AND CORPORATE GOVERNANCE (2006).

248. *See supra* Section I.A.

249. *See* STIGLITZ, *supra* note 12, at 82.

supported by the many constituents of the corporation, including, in the broadest sense, the public. Since executive compensation continues to be a controversial issue among shareholders and other corporate constituents, it is a powerful signaling device.[250] Employee voting can legitimate high executive compensation. Suppose the CEO's pay package was approved by shareholders and employees, and, informed by this advice, a board exercises its independent judgment and awards high compensation. The compensation is legitimated not only by the legal authority of the board under corporate law, but also publicly legitimated in some sense by the approval of all major constituents of the corporate enterprise.

IV. POTENTIAL OBJECTIONS

A. Information Quality

A potential objection to employee monitoring is that employee voting will not yield quality information. The vote could be tainted by irrelevant, heterogeneous considerations, or incomplete knowledge. For example, objectors could argue that voting could be tainted by personal feelings toward the CEO, sociopolitical agendas of individual workers or their unions, social and economic class envy, standardless measures of proper salaries, limited knowledge of firm performance and economic metrics, etc.[251] A key difference between shareholders and employees is that shareholders, for the most part, vote with principally one criterion in mind—stock value.[252] Employees may apply multiple criteria. The objection questions the reliability of the information elicited.

This objection is flawed. Firstly, the largest portion of the voting class are middle and senior level managers who would be, as a collective whole, highly knowledgeable about the performance of both the company and its most senior officers. These managers already evaluate inferior employees and participate in the setting of their salaries, and they may themselves be subject to 360 evaluations from their subordinates. Presumably, these managers would also apply in good faith the same professional standard of conduct to the evaluation of company and senior officer performance. There is no reason to believe that, when it comes to the evaluation of the CEO, employees discard professionalism; and if it is the case, that fact may be material

250. PHAN, *supra* note 22, at 155.

251. *Cf.* Zohar Goshen, *Voting (Insincerely) in Corporate Law*, 2 THEORETICAL INQUIRIES L. 815, 819–30 (2001) (discussing the problem of strategic voting or conflict of interest voting among security holders in a way that deviates from efficient outcome).

252. *See supra* note 128 and accompanying text.

information on the CEO's leadership quality and the perception of confidence, which is an important job qualification of a chief executive.

With respect to the limits of employee knowledge, it is true that no single person—including the CEO or a board member—holds perfect knowledge of all inside information. But a suggestion that an employee is disqualified due to a lack of perfect knowledge is a straw man argument. Information is never perfect in the sense of transparency of knowledge, preferences, and motivations. The real question is whether the information is relevant and material, as well as the cost and the benefit of procuring the information.

A firm is the collection of its employees, each holding a unique packet of information. In this respect, a firm can be seen as an information exchange.[253] If so, the voting outcome would in many cases accurately reflect the collective information held.[254] In any individual vote in any voting scheme, opinions determining the vote may be misguided or ill-informed. Mass voting, such as political voting, is messy in the sense that voter preferences are heterogeneous and any number of factors may influence an individual vote. However, systemic errors are difficult to achieve since random errors tend to cancel each other. Any outcome that adopts a systemic view would reflect the overall information held within the corporation.[255]

Although employees may bring different perspectives in the good faith exercise of evaluating performance, their criteria would not be random. On the whole, they would fairly reflect rank in the hierarchy. The higher in the hierarchy an employee is, the more that employee's criteria would seek to evaluate the CEO's job performance and the less they would be sensitive to wage differential. Greater seniority promotes greater affinity and identification with high paying jobs and those who hold them. There may also be some natural affinity toward supporting executive pay. At the lower levels, employees may pose a problem arising from multiple criteria and perspectives. They are the lowest paid workers, and thus would be naturally skeptical of high wages. On average, they may be less educated and less informed about the state of the company than their managers. They may be influenced by

253. *See* BARNARD, *supra* note 205, at 73, 82 (defining an organization as a "system of consciously coordinated activities or forces of two or more persons."); PHAN, *supra* note 22, at 3 ("There is increasing realization that a firm is a place where people meet to exchange specific information for the purpose of engaging in production.").

254. *See generally* SUROWIECKI, *supra* note 206 (discussing how group decisions reflect the aggregated information of the group).

255. *Cf.* Kang, *supra* note 18, at 1316–17 ("Voting in government elections nonetheless effectively translates public preferences. . . . One consequence of retrospective voting is that elections often are effectively a referendum on the incumbent's performance, particularly when the incumbent is in the race.").

organized labor. They are the furthest removed from direct dealings with the CEO. Their evaluations of performance may be uninformed or suspect. The risk of the application of more diverse criteria is greater.

If the lower ranks are problematic, why permit voting by the vast majority of employees? Despite the risks, the lowest rank and file employees serve useful functions in the overall scheme. The possibility of excluding a large majority of employees increases the risk of gaming. Mandatory inclusiveness reduces this risk. There is some benefit to egalitarian inclusion of all employees.[256] Inclusiveness would facilitate political legitimization of executive compensation.[257] From a business perspective, the exclusion of the majority of employees would be demoralizing and undermine organizational cohesion. When a CEO's pay is so large as to absolute amount or wage differential, the expression of collective outrage would serve an important public and governance function. Natural skepticism of high compensation, a systemic bias perhaps, would tend to offset the opposite structural bias held by the most senior executives and board members who are a part of the same social, economic, and professional class.

As discussed earlier, the balance of considerations suggests a weighed voting scheme. Since the voting allocation is based on a reverse pyramid structure, it counterbalances any significant objections based on giving unknowledgeable rank and file employees a controlling block.[258] Neither rank and file employees nor senior officers have the controlling block of votes. That block should be held by the middle and senior managerial ranks. The assigned weights acknowledge the potential risks to information quality. These benefits and countermeasures outweigh the particular problems of information quality at the lower employee level.

B. Rationally Apathetic Employees

Like political citizens or corporate shareholders, employees may be rationally apathetic. Like political voting, employees may think that the personal cost-benefit of voting is not worth it, or that their single vote (vote allocation) may not make a difference. Some employees may

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256. *See* HIRSCHMAN, *supra* note 25, at 76–105 (describing the benefit of loyalty engendered by members having participatory voice in an organization).

257. *See supra* note 164.

258. For example, suppose 90% of a company's employees can be called "rank and file" and they hold 10% of the vote allocation. Even if all 10% of the vote is voted "Against" (a probabilistically unlikely outcome), the remaining 90% of the vote is held by 10% of the managerial ranks who would be the most knowledgeable voters. The 10% "Against" votes would not sway the outcome in most cases.

not care at all about the issue at stake. Some may consider the right a chore without any tangible payoff. Such objections do not withstand scrutiny because there are significant differences between political or shareholder voting and employee voting.

In political voting, there is not an insignificant cost, which is time off from work or leisure and trekking to the voting booth. If this cost of political voting did not exist, voting turnout would be far greater. In contrast, employee voting is virtually cost-free. Waiting and procedural processing are not involved. Voting can be done online, and at work. The most significant cost to the employee is the time used to weigh the amount of pay with the executive's performance. This consideration, while real, is not time consuming in the mold of performing the employee's job. It would be in the mold of a judgment call: Given the company's performance and trajectory and the CEO's responsibility for them, has the CEO earned the proposed compensation? Employees will already have a good sense of the company's performance, trajectory, and the executive's performance. Due to weighed voting, those who have the best information have greater voting power, and thus also have the incentive to vote.

A problem with the rationally apathetic shareholder is that the shareholder may not have very good information on the issues put to them. The benefits of diversification increases the work required to be informed. If so, this calls into question the informational quality of the vote and the motivation to vote. Consider the most basic shareholder governance function—voting on directors. Suppose the shareholder holds a modestly diversified portfolio of thirty stocks[259] and each company has a ten-member board with no cross memberships. A shareholder may not have good opinions about each of these three-hundred directors. Rational apathy and situational ignorance may be related.

Employees are situated differently. They know a great deal about the company, its competitors, its position in the competitive landscape, and its trajectory. In many companies, the information flow within the firm is complex and efficient. Unlike shareholders and the many directors and officers in their portfolios, employees will have greater information and familiarity with the senior executives of the company. Since they have more information and their voting is almost

259. *See* Meir Statman, *How Many Stocks Make a Diversified Portfolio*, 22 J. FIN. & QUANT. ANALYSIS 353, 355 (1987) (showing that a portfolio of 30 stocks would result in an expected variance of under 20.87%, whereas a portfolio of 1000 stocks would result in an expected variance of 19.21%); *see also* Robert J. Rhee, *The Madoff Scandal, Market Regulatory Failure, and the Business Education of Lawyers*, 35 J. CORP. L. 363, 372 (2009) (suggesting that significant diversification can be achieved with a mix of 30-35 stocks).

costless, the degree of apathy seen in shareholders will tend to be less in employees.

Lastly, employees are more motivated to vote than shareholders. They have undiversified firm-specific investment in their career.[260] In cases where employees are vested in their careers and "exit" is far from frictionless,[261] they will have incentive to vote and participate so long as adequate measures are taken to protect confidentiality.[262] This incentive arises from different motivations and sentiments. Voting would be almost cost free, and so the degree of shirking would be less. We can also assume that as a collective whole, unless morale has deteriorated, employees care about their company and its prospects. The principle of meritocracy undergirds the sense of fairness in a competitive market society. Thus, employees would be motivated to speak on the issue of fairness in wage and sharing of economic production.

C. Balance in Corporate Governance

In U.S. corporate governance, employees have had few formal roles. Most boards of public companies do not have employee representatives,[263] and senior executives typically view their relationship from a hierarchical perspective where they transmit information and directives down the chain of command. Corporate law does not prohibit a corporation from establishing greater employee participation, but this is not the practice among public companies. A potential objection may be that employee voting would significantly alter the balance of power in corporate governance away from the traditional triad of board, management, and shareholder. This concern is unfounded.

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260. *See* BLAIR & ROE, *supra* note 29, at 58–87; Margaret M. Blair & Lynn A. Stout, *Specific Investments: Explaining Anomalies in Corporate Law*, 31 J. CORP. L. 719, 738 n.60 (2006) (noting that employees make undiversified firm-specific investments).

261. *See* HIRSCHMAN, *supra* note 25, at 21–29 (describing a constituent's choice of "exit" or "voice" whenever an organization is perceived to be declining or unsatisfactory to the member).

262. *See supra* Section II.C.

263. The U.S. corporate governance system is different from countries like Germany that carves out a formal role for employees in its system of codetermination. *See generally* JOHN T. ADDISON, THE ECONOMICS OF CODETERMINATION: LESSONS FROM THE GERMAN EXPERIENCE (2009) (discussing the German model of codetermination); BLAIR & ROE, *supra* note 29, at 163–238; IRENE LYNCH-FANNON, WORKING WITHIN TWO KINDS OF CAPITALISM: CORPORATE GOVERNANCE AND EMPLOYEE STAKEHOLDING: US AND EU PERSPECTIVES (2003) (comparing the European model of corporate governance, which has a greater role in employee participation than the US model); David Charny, *The German Corporate Governance System*, 1998 COLUM. BUS. L. REV. 145, 145–66 (1998) (same).

If the objection is that employee say-on-pay may influence the board, this is no objection at all. That is the stated purpose. Legally, say-on-pay does not diminish or change the board's legal authority to manage the affairs of the corporation.[264] It is an advisory vote. At most, say-on-pay exerts soft constraints on the board's virtually unfettered legal authority inherent in the business judgment rule.[265]

Ideally, say-on-pay *should* influence the board. When shareholders leave the couch of apathy, their opinion on executive compensation is relevant to the mix of information. Employee opinion is also relevant. Employees observe the CEO on a daily basis. They implement the CEO's strategies and decisions, and they are well-positioned to assess the efficacy of corporate decisions, the CEO's performance, and leadership. These points are obvious and uncontroversial. So why wouldn't directors, in good faith, want to know the opinion of employees to be better informed in their decision-making? The answer cannot be that such opinions are wholly irrelevant or immaterial.[266] The answer must be that directors do not want additional constraints on their decision-making, which is no legitimate answer when the additional constraint promotes informed decision-making.

Communicating relevant information to the board is a core function of corporate governance. Say-on-pay does not contain a complex or overwhelming amount of information, and it does not displace a board's ultimate business judgment. Employee voting does not tilt the balance in corporate governance, formally or informally. It is consistent with the ideal that boards are the ultimate managers but that their decisions should be informed. In the final analysis, the provision of relevant information to the board, so long as its production and assimilation is not so costly as to be counterproductive, is always a good thing.

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264. Dodd-Frank Wall Street Reform and Consumer Protection Act, Pub. L. No. 111-203, § 951, 124 Stat. 1376, 1899–1900 (2010) (codified at 15 U.S.C. § 78n-1 (2012)).

265. *See id.* (providing that the vote is advisory). There has not been a Delaware case striking down executive compensation on the theory of excessiveness of amount. Where compensation have been disapproved, the theory must be some showing of a breach of the duty of loyalty, including bad faith, or corporate waste. *See, e.g.*, Weiss v. Swanson, 948 A.2d 433, 450 (Del. Ch. 2008) (involving "spring-loaded" stock option grants in which options were granted immediate prior to favorable press announcement); Ryan v. Gifford, 918 A.2d 341, 357–58 (Del. Ch. 2007) (involving back dating of stock option grants).

266. *See supra* Section III.A.

D. Employee "Hold Up"

Another objection could be that employee monitoring would create an employee "hold up" problem. If compensation would depend in part on employee approval, the tacit understanding may be that a CEO should keep employees happy even though this may undermine firm profitability and shareholder value.[267] She could raise salaries of employees because this would narrow the wage disparity ratio. Or, she might not go ahead with needed layoffs because it would be unpopular. Employee voting, perhaps in some organized fashion, could be used as a coercive "hold up" device.

There is some merit to the "hold up" objection, though it ultimately does not withstand closer scrutiny.[268] If employee approval is a factor in pay decisions, CEOs may become more sensitive to the approval of employees. With respect to the distribution of the corporation's gains among management, shareholders, and employees—the principal internal constituents having claims on production gains—if employees get a little more than they do currently, it should not be a cause for alarm. Minimum wage laws do precisely this as between shareholders and employees, absent perfect pass-through to customers in the form of increased prices. It is true that a newly formed device of corporate governance may create distributional effects. Currently, executives get a large share of the gain from production as compared to employees.[269] This raises an issue of equity and fairness in the corporate enterprise. Laws often have such distributional effects. Corporate law is not neutral to distributional

267. *See* Dau-Schmidt, *supra* note 25, at 804–05 (suggesting that active employee participation in corporate governance can "help hold management to the equitable treatment of workers under long-term implicit deals").

268. *See* Bagchi, *supra* note 28, at 876 (noting that potential conflict exists between employees and shareholders with respect to the distribution of wealth and imposition of costs).

269. *See* Mishel & Davis, *supra* note 4, at 3 & tbl.1 (indicating that CEO pay has greatly outpaced the income of workers).

effects.[270] There are many corporations in history[271] and currently[272] that pay employees very well.

Any scenario of a "hold up" would be fluid and not subject to easy or simplistic generalization. The "hold up" problem dominates if CEOs are substantially captured by employees, such that there are significant questions of efficiency. Large business decisions and strategies—such as mergers, layoffs, strategic outsourcing, labor contracts, and the like—should be made only in the interest of the corporate enterprise.[273] A merger not consummated to protect employee interests may be just as bad a merger as one consummated to increase the CEO's empire and pay. But the risk of a dominant "hold up" is minimal because alliances, interests, circumstances, and a multitude of factors make decision-making in the corporation fluid and not subject to a dominant factor.

Rank and file employees should not be given the controlling block of votes;[274] management should control. By virtue of a pyramidal corporate hierarchy, managerial employees constitute a minority in numbers, but they would hold the controlling block of votes. They are already higher paid than most employees in the firm. Thinking like a manager means that managers are sensitive to the fact that wages and salaries are reported as a firm's expenses. If a manager is responsible for a particular profit and loss (P&L) or the financial performance of an entire business unit or product line, her salary and bonus may depend on the P&L, as is commonly seen in business practice. There would be

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270. Many rules in corporation law and corporate financing affect distribution among different corporate constituents. *See, e.g.*, Orban v. Fields, Civ. A. No. 12820, 1997 WL 153831, at *10–11 (Del. Ch. Apr. 1, 1997) (ruling that board's hostile action to dilute common stockholder in favor of preferred stockholder interests was legitimate); Credit Lyonnais Bank Nederland, N.V. v. Pathe Comm'n Corp., Civ. A. No. 12150, 1991 WL 277613, at *34 (Del. Ch. Dec. 30, 1991) (ruling that fiduciary duty shifts to creditors when the corporation is in the zone of insolvency); Katz v. Oak Indus. Inc., 508 A.2d 873, 881–82 (Del. Ch. 1986) (ruling that bondholders have no recourse when the corporation engages in a coercive exchange offer); Metropolitan Life Ins. Co. v. RJR Nabisco, Inc., 716 F. Supp. 1504, 1524–25 (S.D.N.Y. 1989) (ruling that bondholders have no recourse for lost value when the corporation engages in a leverage buyout).

271. *See, e.g.*, Dodge v. Ford Motor Co., 170 N.W. 668, 671 (Mich. 1919) (noting that Henry Ford wanted "to employ still more men, to spread the benefits of this industrial system to the greatest possible number, to help them build up their lives and their homes"); HENRY FORD: MY LIFE AND WORK: AN AUTOBIOGRAPHY OF HENRY FORD 116–30 (1922) (noting that Ford set a minimum wage of five dollars per day, increased to six dollars, and that he believed in "paying good wages").

272. Investment banks typically pay their employees very high wages, which have been typically in the range of forty to fifty percent of net revenue. *See supra* note 156.

273. This is defined as the long-run value of the firm including the value of all securities. Michael C. Jensen, *Value Maximization, Stakeholder Theory, and the Corporate Objective Function*, 12 BUS. ETHICS Q. 235, 236 (2002).

274. *See supra* Section II.B.

a natural resistance to any unfettered or unprincipled attempt at a wage "hold up."

In important transactions, the considerations and influencing factors may be much greater than the isolated interplay between management and employees. CEOs report to the board. They are subject to market pressures such as stock price, activist shareholders, and Wall Street. They are influenced by the market for corporate control.[275] Like other employees, they are influenced by concerns for their professional reputations and the next job, which is the market process of ex post "settling up."[276]

Assume, for example, the CEO is forced to do the one thing that will alienate employees the most—layoffs. As a result, disaffected employees vote against the CEO's pay package, which is large because the board felt it needed to incentivize a talented CEO and pay for her opportunity costs. Two years have passed, and the drastic move turned out to be the right one. The company was saved and is moving toward financial health again. Would a board deciding on compensation be able to put the negative employee vote in the context of the situation and make an informed, independent judgment on the pay's merits? A professional board, acting in an informed basis, would be able to contextualize the negative vote by employees. One also suspects that in the reporting process, the senior management, the only internal group that has routine, direct access to the board, would duly explain why employees are unhappy with management and why this unhappiness is not correlated with the best interests of the corporation.

In the final analysis, employee "hold up" would be marginal on the whole when the board and the management are confronted with a multitude of complex factors in corporate decision-making. When there is a fundamental conflict between the preference of employees and a corporate action, employee "hold up" simply becomes a factor in determining the effects of the action on the many stakeholders of a corporation.

275. *See* Henry G. Manne, *Mergers and the Market for Corporate Control*, 73 J. POL. ECON. 110, 112–14 (1965).

276. *See* Eugene F. Fama, *Agency Problems and the Theory of the Firm*, 88 J. POL. ECON. 288, 295–306 (1980) (suggesting that labor market should create proper incentives through "ex post settling up"). *But see* Rhee, *supra* note 77, at 1176 (arguing that "the current problem of excessive executive compensation calls into question whether this 'settling up' process is efficient, or even works when the amount of compensation diminishes an executive's long-term incentives.").

E. Political Objections

Another objection is political. The most visceral objection, and perhaps an unspoken one at that, may come from a conviction that employees, managers or not, have no place in opining on the pay packages of senior executive officers. Some CEOs may be threatened by the notion that employees would be evaluating them and approving their pay packages, and some board members may dislike further constraints and considerations imposed on their usually-unfettered discretion to make business judgments. There may be strongly held convictions on social, political, and class order among some in the elite economic, business, and societal communities. Economists have long recognized the influence of social and economic class on behavior, attitudes, and consumption.[277] These strong objections can coalesce into a concentrated political interest group, which would vigorously oppose the idea of employee monitoring. Senior executive officers as a political interest group have not warmly embraced the concept of shareholder say-on-pay,[278] but the objection lost the political battle. The financial crisis of 2008-2009 resulted in strong political support for corporate and financial market reform. Shareholders' participation in corporate governance is now firmly established in corporate law. On the other hand, employee say-on-pay would run into strong political headwinds since the principle of employee voting in corporate governance would be perceived as novel. The political objection is relevant not on the merit of the idea but as a pragmatic matter, even if some of the underlying premises based on notions of class privilege are true, they would be dubious and socially suspect.

However, politics is not always the death knell of sound reform. The idea of employee monitoring is both pragmatic and politically feasible. As with any major reform, such as the Sarbanes-Oxley or Dodd-Frank Acts, a public perception of the necessity of reform drives the legislative process. The idea of employee monitoring is legally and economically sound in theory. One cannot predict the brew of political, economic, and social circumstances that would overwhelm concentrated political opposition. It could be that social inequity reaches a tipping

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277. *See, e.g.*, THORSTEIN VEBLEN, THE THEORY OF THE LEISURE CLASS (1899); *see also* William Hildred, *Executive Consumption: Not Conspicuous but Still Invidious*, *in* THORSTEIN VEBLEN IN THE TWENTY-FIRST CENTURY: A COMMEMORATION OF *THE THEORY OF THE LEISURE CLASS* (1899-1999) 85–101 (Doug Brown ed., 1998).

278. *See* John C. Coffee, Jr., *The Political Economy of Dodd-Frank: Why Financial Reform Tends to be Frustrated and Systemic Risk Perpetuated*, 97 CORNELL L. REV. 1019, 1025 n.24 (2012) (noting that corporate executives opposed say-on-pay); Randall S. Thomas & Christoph Van der Elst, *Say on Pay Around the World*, 92 WASH. U. L. REV. 653, 659 (2015) (noting that shareholder proposals under Rule 14a-8 for say on pay were opposed by corporate executives).

point or another corporate or financial crisis occurs, galvanizing the political forces needed for further reform.

Furthermore, the debate on executive pay is a global one. Shareholder say-on-pay was first implemented in the U.K. and then rapidly adopted in continental Europe and other common law countries, including now the U.S.[279] In other parts of the economically advanced world, the role of employees and labor in corporate governance is more prominent than in the U.S. and the relationship is more comfortable and familiar.[280] It is conceivable that a formal role of employees as compensation monitors may be adopted first in other parts of the world, and then later imported into America as was the case with shareholder say-on-pay. The legislative process is always difficult. The fact that say-on-pay as a corporate governance phenomenon has been so widely adopted across advanced economies suggests that there are limits to the political power of corporate executives. Despite opposition from concentrated political interest groups, employee say-on-pay could be politically feasible.

CONCLUSION

Few would dispute that in most companies the CEO should be the highest paid employee, that they should be well compensated compared to others for good performance, and that they should be entitled to personal wealth after a successful tenure of value creation. However, the extreme pay of a single senior employee in a corporation raises the issue of corporate efficiency and income inequality, and these issues spillover into the broad public and political discourse. The case for employee monitoring is compelling. Employees can monitor senior executive performance better than shareholders because they possess inside information, and they have direct incentives to monitor. Employee monitoring is feasible and cost effective. Employee input leverages all of the information held in the corporation, and it can assist the board in making an informed decision on executive pay. Employee approval can also politically legitimize executive compensation in an era in which executive pay and income inequality have touched the public consciousness.

The benefits of employee monitoring outweigh the objections. Concerns about information quality can be controlled through weighed voting. Employee monitoring does not fundamentally shift the balance of power in corporate governance. Legal power still resides with the

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279. *See supra* Section I.C.

280. *See supra* note 263.

board, but the board must now simply consider additional relevant factors in making an informed decision. The interests of shareholders and employees are not categorically inimical to each other. The use of employee input can advance the interest of shareholders in insuring that executive pay is tied to performance and does not reach grossly excessive levels due to rent extraction through substantial control and influence over the levers of corporate power that set compensation.